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U.S. ECONOMIC GROWTH AND THE THIRD WORLD DEBT

ORIGINAL

HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL
ECONOMIC POLICY, OCEANS, AND ENVIRONMENT

OF THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

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ON

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U.S. ECONOMIC GROWTH AND THE THIRD WORLD DEBT

WEDNESDAY, OCTOBER 9, 1985

United States Senate,
Subcommittee on International
Economic Policy of the
Committee on Foreign Relations,
San Francisco, CA.

The subcommittee met at 9 a.m., pursuant to notice, in hearing rooms A, B, and C, second floor, World Affairs Center, 312 Sutter Street, San Francisco, CA, Hon. Charles McC. Mathias (chairman of the subcommittee) presiding.

Senator **Mathias**. Ladies and gentlemen, this session of the Senate Foreign Relations Committee's Subcommittee on International Economic Policy will come to order.

I regret that other members of the subcommittee who hoped to be here have been detailed in Washington because of the debate there on the problem of extending the limit on the national debt.

That is a subject which is of great importance. And the fact that I have come here doesn't in any sense diminish its importance in my eyes. But I think the subject that we are met here to talk about is also of great importance.

So, I thought it was useful to carry out the plan of holding these hearings in San Francisco as had been scheduled.

We are to hear testimony on the subject of the U.S. Economic Growth and the Third World Debt. It is a subject not unrelated to the debate that is now going on in the Senate in Washington because there is a definite relationship between the Third World debt and the health of the U.S. economy.

The Foreign Relations Committee has explored this topic in hearings in Washington on a number of occasions, but this is the first time we have had the opportunity to come to the west coast and to receive expert testimony.

It is very fitting that we should meet in San Francisco and hold the session in the meeting rooms of the World Affairs Council because the Foreign Relations Committee has benefited tremendously—particularly in the past year—from the research and analysis that has been undertaken for it by the Bay Area International Forum of the World Affairs Council.

Since the study which resulted from that research has already appeared in the Congressional Record, I am not going to include it in full at this point in this record.

But I will incorporate it by reference to the Congressional Record of Thursday, May 9, 1985, in which a copy of that report appears.

I want to pay particular tribute to Peter Jones and to Albert Fishlow who have devoted a great deal of time and effort to this project. Their work was not done when they submitted their report because they both will be important witnesses in the hearing today.

For the next day and a half we intend to explore issues which affect the lives and well-being of all Americans. We will have the opportunity to hear from an impressive list of distinguished witnesses.

I suspect that we have fallen into a kind of a trap in Washington by separating economic challenges that we face into discrete packages. Very often, as issues come before the Congress for decision, they come as individual pieces of legislation.

Two years ago, at the time we considered the International Monetary Fund legislation, Washington was deep in the problems of a debt crisis. We met that challenge. We passed that legislation. Then we moved on to other issues.

But the world debt crisis is very far from over. The fact that we passed one piece of legislation in Washington didn't completely eradicate it. And indeed it may well have entered a more dangerous and ominous phase with implications not only for the debtor nations—for those nations that are confronted with the burden of debt service and debt repayment—but dangerous also for the developed economies of the world.

We are coming to realize that Third World debt problems cannot be isolated from economic issues which are more visible, more present to most Americans—issues such as the American trade deficit and the U.S. budget deficit.

Dealing effectively with the world debt crisis includes insuring markets for debtor nations' exports, maintaining reasonable financial flows to these countries, not permitting their debt servicing burdens to become so onerous that they become politically unsupportable.

But success in these areas means that industrial countries cannot raise protectionist barriers to trade, must keep private, bilateral, and multilateral funds flowing to debtor nations, and must reduce the upward pressure on interest rates by reducing budget deficits.

It seems to me that Americans above all need to recognize that we have a stake in the economic well-being of other nations. This is not a charitable enterprise. We have a direct stake in the economic well-being of other economies, other nations.

We remain the largest single exporter in the world. A large percentage of our exports are sent to developing nations. And when they are unable to buy our exports, we lose. We lose in jobs. We lose in business activity. We lose in profits.

To know what this means in practice rather than simply in theory it is only necessary to look a short distance south to Mexico. In 1981, the United States exports to Mexico were over $17 billion.

But by 1983 when the economy of Mexico had plunged into deep trouble our exports to Mexico had plunged to under $9 billion. So, there was an immediate, direct impact on the U.S. economy for the economic troubles in Mexico.

I would hope that during the next day and a half we can focus attention on the interconnections between the variety of economic challenges Americans face. And beyond that we look for some advice from the witnesses who will appear here on the prudent, practical measures that we should be taking as a Nation to deal with the challenges that face us.

The Secretary of the Treasury, James Baker, has made certain recommendations at the World Bank/IMF meetings in Seoul, Korea. And he will be appearing before this committee—before the Foreign Relations Committee very shortly to report on these new U.S. initiatives.

So, it will be useful for the committee to have on the record any initial reactions the witnesses may have to Secretary Baker's speech in Seoul.

To open the testimony I am going to call on Mr. Peter Jones, who has been so instrumental in structuring these hearings and ask him to make an opening statement.

Mr. JONES. Thank you, Senator Mathias. You were one of the leaders of the battle to get the $9 billion IMF supplementary capital increase passed through the Congress.

It finally passed the House of Representatives by only seven votes. And when that occurred much of official Washington heaved a sigh of relief and announced that the battle was won and problems were over.

At that point you were one of the first in Washington to say that in fact, indeed, the battle has just begun. And so over a year ago you initiated a series of correspondence with John Place and George Keller, successive chairmen of the Bay Area International Forum, to ask scholars at Stanford, the Hoover Institute, Berkeley and leaders of the business community to take a look at these ongoing and increasingly serious problems.

That led to the formation of a steering committee of business and professional leaders in this town and a research committee of outstanding scholars from Stanford, Hoover, Berkeley, and a study of the 2 years of hearings that you conducted on these issues leading up to the IMF $9 billion supplemental.

A copy of that report which you referred to earlier is here with us today. It was worked on by the Steering Committee and Research Committee and approved by the Executive Committee of the Bay Area International Forum.

As you said, at that point further correspondence between you and George Keller led to the conclusion that you felt it was important to come to the west coast to hold these hearings that you are now conducting because of your own sense over a year ago that the debt problem was going to get worse before it got better. And that is why we are here today.

The morning session will involve an economic overview by Professor Fishlow, a political overview by Secretary Habib, and then comments on major OECD macro-economic policies and their impact on U.S. growth and the debt crisis by both Prof. Ron McKinnon from Stanford and Bob Heller, the head of International Economics at the Bank of America.

This afternoon we will look at developing nation policies, U.S. trade policies, and oil policies. And tomorrow morning—foreign direct investment and technology transfers.

The hearings will then culminate with the key issue of all: Private voluntary credit flows to these debtor nations, evidence that they are inadequate, and the need for a larger role by the multilateral agencies. That is the agenda.

We are here thanks to you. And we will begin with Albert Fishlow's economic overview.

STATEMENT OF PROF. ALBERT FISHLOW, UNIVERSITY OF CALIFORNIA AT BERKELEY

Mr. FISHLOW. The current debt problem of developing countries reflects both the changing trend of international interdependence in the postwar period as well as the turbulence of the last decade.

It is only because developing countries increased their degree of international integration in the 1960's that they were able to begin to borrow from the Eurocurrency market at the beginning of the 1970's.

They became credit worthy on the basis of better economic performance—measured both by increased rate of economic growth as well as by progressively more competitive exports of manufactured products.

Against that backdrop of gradually increasing interdependence the sudden quadrupling of oil prices in 1973–74 ushered in the most difficult period of international economic adjustment since the Great Depression.

The industrialized countries did not fare particularly well. Inflationary pressures coincided with declining growth and some of the divergences in response continued to be noticeable among the OECD countries—high unemployment rates in Europe, relative Japanese export success, and the U.S. conversion to tighter monetary policy.

What stands out most perhaps is the failure of various efforts at coordinated industrialized country response, whether in the guise of the Carter efforts or subsequent economic summit undertakings.

Developing countries at least initially did better. More opted for either intensified export orientation or debt-financed adjustment than for lower growth as a way to compensate for the adverse effects of higher oil prices.

Debt, in particular, was a very attractive course open to those middle-income countries that had already begun to borrow on capital markets.

Interest rates, deflated by export unit values of indebted countries, fell to minus 25 percent in 1974 and were on balance negative from 1973 to 1980. Market signals and eager bankers all encouraged indebtedness.

Recycling of petrodollars from surplus oil exporters to oil importing developing countries—and some developed countries as well—was the basis of first accommodation to the radical realignment of the international balance of payments.

What happened next were a policy mistake and a deterioration in external conditions. The first consisted of continuing borrowing of some developing countries that enables them to put off adjustment to the new structure of energy prices.

With cheap money substituting for cheap oil it was possible not only to finance balance of payments deficits but to utilize the external saving for increasing investment.

The problem at this time was not so much capital flight—that happened later—as commitment to projects with long maturity and an excessive stimulus to expansion of the public sector.

Such a strategy exposed countries to a high level of vulnerability to changes in external conditions. That of course eventually happened with the rise in oil prices in 1979.

It ushered in a set of adverse impacts that quantitatively—at least for most countries—swamped the reckless component of borrowing in the 1970's.

In addition to the direct increase in imports occasioned by higher oil prices and a recession more severe than the 1974-75 experience there was an abrupt rise in real interest rates in 1981 and 1982.

The latter was the decisive factor impinging upon all debtors. It explains why the first large developing country to find itself unable to pay was an oil exporter, Mexico, that had benefited from improving terms of trade.

At this moment of crisis emergency efforts were undertaken to arrange new liquidity under the auspices of the IMF and to assure the stability of the international financial system.

The novelty was the conditionality imposed on commercial banks. Unless they lent and rescheduled, there would be no IMF support and therefore less likelihood of repayment.

By this means the IMF succeeded in discouraging individual banks from withdrawing and thus drew attention to their central importance in any solution. Put another way—the IMF quasi-socialized and cartelized bank relations with problem debtor countries as it also designed stabilization programs for these countries to follow.

The experience with Mexico was to be replicated with several others but was prominently in Latin America.

With progressive industrialized country recovery led by President Reagan's open economy Keynesian budget deficits increasingly financed from abroad it appeared to many in early 1985 that the debt crisis had been definitively resolved.

The focus was on solution through developed country—rather than developing country—growth. Demand for exports would provide the foreign exchange debtors needed to service their debt.

In particular, the United States increased its imports by 27 percent in 1984. It was resolving the debt problem as a buyer of last resort rather than as a lender of last resort.

Such optimism has not been confirmed over the course of 1985. It has been replaced by growing concern for three reasons. One is that export performance has not held up in 1985.

Even the super East Asian success stories are facing reductions in revenues this year as the U.S. growth rate has come down to well below 3 percent. Other industrialized country importers have not taken up the slack.

These reductions in receipts have prevented the gains from declining interest rates from being realized by debtor countries.

In the second place, anticipated capital flows have not materialized. Commercial bank lending is down to the largest debtors now that the first involuntary phase of further credit has ended.

Where there is lending it is primarily to some of the East Asian countries, not the problem cases. The implication is a continuing large outward flow of interest payments from debtors that is not offset by new borrowing.

In 1983 and 1984 Latin America has averaged about $30 billion a year in excess of interest payments over new loans. This year should be little different.

Third, debtor countries have tired of the cost of stabilization. What they perceive are large trade surpluses enabling the payment of interest but weakened internal economies.

What the IMF Programs promise is a close relationship between the balance of payments and internal economic performance. Instead, what the largest Latin American debtors perceive is a marked dichotomy.

The balance of payment surplus has been achieved at the expense of continuing stagnation, high real interest rates and low-real wages, low rates of investment, high inflation, and the prospect of more to come.

It is not simply the governments are responding to popular and populist protests in rebelling against more austerity. It is the increasing concern that the interest payments of the order of magnitude of 5 to 7 percent of gross product deprive the economies of the basis for meaningful adjustment through needed capital formation.

It is the concern that the inability to import an adequate amount prejudices economic efficiency and contributes to inflationary pressures. Remember that the largest debtors have been forced to reduce their imports dramatically—in the case of Latin America, by some $40 billion between 1981 and 1983 through sharp reductions in internal expenditures.

The reaction of the debtor countries is thus more than a desire to shift the larger share of the burden of the debt problem to their creditors or a mere desire to avoid unpleasant austerity.

It is also rooted in the conviction that a change in policy toward more expansion is necessary if countries are going to have an adequate basis for servicing their debts.

We have thus come to a new decisive phase of the problem. The initial crisis has been surmounted and the international financial system has emerged substantially unscathed despite reschedulings and substantial interest arrears.

No widespread writing down of debt has been necessary and no associated bank failures. Debtor countries have demonstrated a capacity for sacrifice and balance of payments adjustment that few would have credited only a few years ago.

There are two broad options available at this point. One is adequate recuperation of developing country growth such that by 1990 they will at least have been able to surpass the standard of living attained in 1980 with prospects for sustaining that expansion.

The other is continuing lack of recovery and with it increased likelihood for the debt problem to reignite into crisis with wider political—and not only economic—consequences.

The World Bank, the IMF, the Inter-American Development Bank, UNCTAD, and many private analysts have produced such alternative scenarios in recent years. While there are some differences in emphasis, the most important factors common to the better and worse cases are readily identified.

For a return to developing country growth they imply on the side of industrialized countries growth rates of an order of 3 to 3½ percent per year, stable or further declining real interest rates, and no increase in protectionist barriers to debtor country imports.

On the side of the developing countries they include a continuing realistic set of exchange rates to induce adequate export growth, reduction of inflation and interest rates, resumption of private investment, and conversion of the public sector into a positive saver or, at least, a smaller dissaver.

And even with a realization of these conditions what is necessary is the availability of adequate credit flows to finance current account deficits. The poorer results correspond to circumstances evoking smaller expansion of their exports, larger service payments on the debt, and higher rates of import growth in the developing countries.

These correspond to inadequate industrialized country performance as well as policy failure in the developing countries. In the IMF scenarios at least the former had much greater consequence than the latter.

Poor industrialized country results, including continuing budget deficits in the United States in the same proportion as currently the gross product, can reduce developing country growth from 6.4 percent annually to 2.3 percent annually.

Poor developing country policies impose a lesser penalty from 5.7 to 3.7 percent. Note that there is a direct tradeoff between trade and credit in these calculations. The less capital inflow that is available, the harder debtor countries must strive not only to export but also to restrict imports.

Large trade surpluses are an inevitable counterpart to large interest payments uncompensated by new borrowing. There is a conflict between bankers unwilling to lend more and exporters eager to sell more.

There is also a relationship between the rate of growth of developing countries and the credit flows they receive. Inadequate financing for a given rate of growth of exports means that lower levels of income must he attained to achieve balance of payments equilibrium.

In order to achieve the high case of 5.5 percent growth developing countries, according to World Bank estimate, must be able to count on a current account deficit of $121 billion in 1990.

The comparable estimate for its 4.8 percent scenario is $76 billion in the same year. My own calculation for a 6 percent real rate of growth of exports and a growth rate of 5 percent of developing countries is a still higher $149 billion. It is greater because it is less optimistic on the trade side than the other two.

These varying estimates made clear that there is a wide range in deciding upon the precise capital requirement and how sensitive the answer is to underlying trade—and particularly export—assumptions.

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Optimists tend to emphasize the role of industrialized country growth in limiting the capital requirements through export opportunities. They are clearly right but only up to a point.

There has been a tendency to exaggerate the response of imports from developing countries to the growth rate of the OECD. For the most recent period since 1977 my estimates show that 3 percent growth in domestic demand of OECD countries yields only about a 2 percent volume export growth in developing countries.

In addition, that relationship depends not only upon the level but the composition of OECD growth as the comparison between 1984 and 1985 reveals. It is the United States that derives imports from developing countries.

Such emphasis upon OECD growth also ignores the role of external credit in making available additional saving to compensate for the large shares of gross product that are currently being siphoned off to pay interest.

Exports can satisfy foreign exchange requirements but do nothing to finance needed investment levels. The exclusive focus on the balance of payments distracts from this potential savings constraint.

Still another aspect of the problem is the potential direction of capital flow. The IMF projection showed that more than half the total developing country current account deficit is located in Asia, corresponding to continuing rapid trade and product growth in that region.

That is, the countries that have no debt problem are projected to receive the additional credit. That will not help to finance the debtors of Latin America. Aggregates can thus be highly misleading.

The World Bank estimates spell out where the funds required are going to have to come from. What is clear is the pivotal role of private commercial bank credit to any satisfactory outcome.

Official capital is presumed to increase in real terms over the next 5 years by only 2.3 percent per year. Direct investment fills less than 15 percent of the gap and grows at 4.2 percent.

The key element is private credit growing at 5.1 percent a year in the high case and at minus 9.5 percent in the low case. Up until now, and especially for the most impacted debtors, commercial bank lending has been conforming more to the low case scenario than the high.

That behavior has contradicted the optimistic expectations of a rapid return to voluntary lending. You will recall that not too many months ago after the negotiation of the Mexican multiyear rescheduling the prediction was that Mexico would be the first country eligible for voluntary lending.

Quite apart from the earthquake, Mexico was already having difficulty in persuading the banks to put up a needed $2.5 billion owing to deterioration in its balance of payments.

It is easy to see why the banks do not want to lend anymore. The profit that was available through higher premiums over LIBOR and renegotiaton fees for the earlier reschedulings is no longer there.

Development prospects for countries can hardly appear bright in the midst of high inflation, low investment, and limited growth. On the other side, financial deregulation has turned banks' attention to domestic opportunity.

That is precisely the weakness of the policy structure that was put in place in 1982. Involuntary lending is all that there is for the debtors and it is too small to permit a positive adjustment. It is enough to enable countries to get by with minimal rates of growth and inadequate to support more.

What then happens is a credit-starved adjustment, incapable of producing improvement in the economy and justifying the lack of creditworthyness to begin with. It is a self-fulfilling prophecy in which countries do poorly and banks are right not to lend.

The pity is that an adequate availability of capital would help to produce a favorable dynamic.

Secretary Baker has just announced a new approach to the debt problem in Seoul. Such renewed attention is highly welcome and shows his increasing sensitivity to the louder and louder rumblings in this hemisphere.

The plan responds to several of the issues I have touched upon here. First, it recognizes the importance of renewed growth as a source of political stability as well as economic resources to meet debt service requirements of the developing countries.

Second, it calls for a more aggressive stance by the World Bank and other regional banks in their lending patterns.

Third, it seeks to make the commercial banks an important component of the solution of inadequate capital flow.

Fourth, it differentiates the problem of four African debtors, who do not have the means even to pay back the IMF despite very low debt service ratios, from the situation of the middle income Latin American debtors encumbered by ratios of interest alone to exports of an order of 40 percent.

These features—and perhaps above all, the exercise of the U.S. leadership in moving toward a solution—are to be welcomed. An obvious extension will be support for an early increase in the capital of the World Bank to permit it to expand its share of total lending over the medium term.

So, too, is welcome the administration's emphasis upon maintaining open markets for the exports of the debtor countries.

The principal questions are whether these new initiatives, as they are fleshed out, will provide adequate relief or sufficiently change the present institutional structure.

What has been promised is an increase in bank lending of $20 billion over the next 3 years—or a positive rate of about 2 percent—instead of the actual reduction experienced in 1985.

But that contribution still constitutes a real reduction of 3 percent through the erosion of inflation. Together with expanded official lending, capital inflow to Latin America will perhaps increase by about $10 billion a year compared to a present $30 billion net drain of resources.

A large part of this additional money will compensate for the lack of anticipated increases in export earnings rather than representing a new infusion. It will thus help prevent still another reversal from external conditions.

Mexico alone will claim about half—not in order to build the basis for accelerated recovery but to stay where it is.

Equally problematic is the developing country quid pro quo that is required. What seems behind the offer is a faith in the efficacy of supply side economics in these countries. That is, a significant reduction in the size of the public sector.

While there is broad and growing consensus in these countries that the public sector is bloated—not least because external private capital preferred official auspices—there is less unanimity in favor of extensive privatization of economic activity.

The new civilian leadership in these countries are committed to making the public sector work better, not abolish it. The secret of East Asian success, after all, resides precisely in its developmental state, not alone in the particular exchange rate or monetary policies that are being followed.

Appeal to private investment as the only way to develop harkens back to the advice we gave Latin America in the 1950's, leading to an estrangement and disappointment after closer cooperation during World War II.

Remember also the adverse effects of the ambiguity in the Alliance for Progress about what proportion of promised funds were official and what private. Finally, throughout the region the Chilean experiment is widely regarded as a failure. This is significant emotional baggage.

If the administration concern extends—as it may—to vetting national legislation for the opportunity it affords foreign investors, such an emphasis may quickly lead to a reaction against what is seen as excessive interference.

That would be a pity precisely because of the growing recognition that the private sector has been deemphasized to much.

Note as well that there is a lurking income distribution problem that insistence upon free markets may also irritate. The consequence of the decline in income in Latin America has been a relatively greater reduction for wages than other forms of income.

Indeed, high interest rates have provided favorable incomes to asset holders. The poor look to public policy to ameliorate their situation. They are numerous and they now have the vote.

Any development involved in the region must have broad based, and not merely elite, support. Care should therefore be taken in framing what conditionality requirements are to be imposed lest they be a source of conflict.

This is the more so in view of the voluntarism that will apparently continue to apply to the private banks. That has been part of the weakness of the present institutional arrangements and there are no indications that a better way has yet been found.

In the last analysis, the hope is that the banks will be eager to lend in the new environment. The greater likelihood is that they will not—even if they have not up until now. Part of the need is to evolve an adequate post-commercial banking financial structure rather than continuing to bet on the return of voluntary lending.

In summary, the Seoul initiative should be seen less as a definitive new departure than as a compensation for the disappointing trade and capital flow results in 1985. Many of the fundamental problems remain.

Real interest rates remain well above their historical trend and provoke a net outflow of resources. Maturities of loans are too short, with variable interest rates putting the entire risk on the borrower.

Some smaller countries face a debt overhang that is simply too large to service. Ironically, while we speak of a case-by-case approach, terms are not adjusted to the capacities of debtors to pay.

The Seoul initiative is a step in the right direction in bringing together the developing countries and the banks and in asserting the responsibility of the industrialized countries.

In the last analysis, however, its success will be measured by its quantitative impact upon credit flows and the real opportunities for adequate economic recovery it opens to the hardhit debtor countries.

Resolution of the debt problem is an important part of the international economic agenda. So long as it festers, sustained global economic expansion will be more difficult and the very fabric of interdependence increasingly strained.

We have already seen the consequence of shrinking credit flows upon the free trade regime. In particular for the United States, as it strives to attain renewed industrial competitiveness, the problem debtors of Latin America are natural markets.

In turn, these countries, newly returned to civilian rule in many cases, are a natural bridge to a cooperative relationship with the developing countries more generally.

The debt crisis and our emergency response earned us credit in the region. Putting the problem to rest will earn us more.

[Mr. Fishlow's prepared statement follows:]

PREPARED STATEMENT OF ALBERT FISHLOW

Background

The current debt problem of developing countries reflects both the changing trend of international interdependence in the post-war period as well as the turbulence of the last decade.

It is only because developing countries increased their degree of international integration in the 1960's that they were able to begin to borrow from the Euro-currency market at the beginning of the 1970's. They became creditworthy on the basis of better economic performance, measured both by an increased rate of economic growth as well as by progressively more competitive exports of manufactured products.

Against that backdrop of gradually increasing interdependence, the sudden quadrupling of oil prices in 1973/4 ushered in the most difficult period of international economic adjustment since the Great Depression. The industrialized countries did not fare particularly well: inflationary pressures coincided with declining growth and some of the divergences in response continue to be noticeable among the OECD countries: high unemployment rates in Europe, relative Japanese export success, United States conversion to tighter monetary policy. What stands out most, perhaps, is the failure of various efforts at coordinated industrialized country response, whether in the guise of the Carter efforts or subsequent economic summit undertakings.

Developing countries, at least initially, did better. More opted for either an intensified export orientation or debt financed adjustment than for lowered growth as a way to compensate for the adverse effects of higher oil prices. Debt in particular was a very attractive course open to those middle income countries that had already begun to borrow on capital markets. Interest rates, deflated by export unit values of indebted countries, fell to -25% in 1974, and were on balance negative from 1973 to 1980. Market signals, and eager bankers, all encouraged indebtedness. Recycling of petro-dollars from surplus oil exporters to oil importing developing countries (and some developed) was the basis of first accommodation to the radical realignment of the international balance of payments.

What happened next were a policy mistake and a deterioration in external conditions. The first consisted of continued borrowing of some developing countries that enabled them to put off adjustment to the new structure of energy prices. With cheap money substituting for cheap oil, it was possible not only to finance balance of payments deficits but to utilize the external saving for increasing investment. The problem at this time was not so much capital flight -that happened later- as commitment to projects with long maturity and an excessive stimulus to expansion of the public sector. Such a strategy exposed countries to a high level of vulnerability to changes in external conditions.

That of course happened with the rise in oil prices in 1979. It ushered in a set of adverse impacts that quantitatively, for most countries, swamp the reckless component of borrowing in the 1970's. For in addition to the direct increase in imports occasioned by higher oil prices, and a recession more severe than the 1974-75 experience, there was an abrupt rise in real interest rates in 1981 and 1982. The latter was the decisive factor impinging upon all debtors. It explains why the first large developing country to find itself unable to pay was an oil exporter, Mexico, that had benefitted from improving terms of trade.

At this moment of crisis, emergency efforts were undertaken to arrange new liquidity under the auspices of the IMF and to assure the stability of the international financial system. The novelty was the conditionality imposed on commercial banks. Unless they lent, and rescheduled, there would be no IMF support, and less likelihood of repayment. By this means, the IMF succeeded in discouraging individual banks from withdrawing, and thus drew attention to their central importance in any solution. Put another way, the IMF quasi-socialized and cartelized bank relations with problem debtor countries as it also designed stabilization programs for these countries to follow. The experience with Mexico was to be replicated with several others, but most prominently in Latin America.

With progressive industrialized country recovery led by President Reagan's open-economy Keynesian budget deficits increasingly financed by abroad, it appeared to many in early 1985 that the debt crisis had been definitively resolved. The focus was on solution through developed country, rather than developing country, growth: demand for exports would provide the foreign exchange debtors needed to service their debt. In particular, the United States increased its imports by 27% in 1984. It was resolving the debt problem as a buyer of last resort rather than a lender of last resort.

Such optimism has not been confirmed over the course of 1985. It has been replaced by growing concern for three reasons. One is that export performance has not held up in 1985. Even the super East Asian success stories are facing reductions in revenues this year, as the U.S. growth rate has come down to well below 3%. Other industrialized country importers have not taken up the slack. These reductions in receipts have prevented the gain from declining interest rates from being realized.

In the second place, anticipated capital flows have not materialized. Commercial bank lending is down to the largest debtors, now that the first involuntary phase of further credit has ended. Where there is lending, it is to some of the East Asian countries, not the problem cases. The implication is a continuing large outward flow of interest payments from debtors that is not offset by new borrowing. In 1983 and 1984, Latin America has averaged about $30 billion a year in an excess of interest payments over new loans. This year should be little different.

Thirdly, debtor countries have tired of the costs of stabilization. What they perceive are large trade surpluses, enabling the payment of interest, but weakened internal economies. What the IMF programs promise is a close relationship between the balance of payments and internal economic performance. Instead what the largest Latin American debtors perceive is a marked dichotomy: the balance of payments surplus has been achieved at the expense of continuing stagnation, high real interest rates and low real wages, low rates of investment, high inflation, and the prospect of more to come. It is not simply that governments are responding to popular, and populist, protest in rebelling against more austerity. It is the increasing concern that interest payments of the order of magnitude of 5% to 7% deprive the economies of the basis for meaningful adjustment through needed capital formation, and that the inability to import in adequate amount prejudices economic efficiency and contributes to inflationary pressures. Remember that the largest debtors had been forced to reduce their imports dramatically -in the case of Latin America by some $40 billion between 1981 and 1983- through sharp reductions in internal expenditure.

The reaction of the debtor countries is thus more than a desire to shift a larger share of the burden of the debt problem to their creditors or a mere avoidance of unpleasant austerity. It is also rooted in the conviction that a change in policy toward more expansion is necessary if countries are going to have an adequate basis for servicing their debts.

Prospects for the Medium-Term

We have thus come to a new decisive phase of the problem. The initial crisis has been surmounted, and the international financial system has emerged substantially unscathed despite reschedulings and occasional interest arrears. No widespread writing down of debt has been necessary, and no associated bank failures. Debtor countries have demonstrated a capacity for sacrifice and balance of payments adjustment that few would have credited only a few years ago.

There are two broad options available at this point: one is adequate recuperation of developing country growth such that by 1990 they will at least have been able to surpass the standard of living attained in 1980, with prospects for sustaining that expansion. The other is continuing lack of recovery, and with it increased likelihood for the debt problem to re-ignite into crisis with wider political and not only economic consequences.

The World Bank, the IMF, the Inter-American Development Bank, UNCTAD, and many private analysts have produced such alternative scenarios in recent years. While there are some differences in emphasis, the most important factors common to the better and worse cases are readily identified. For a return to developing country growth, they imply, on the side of the industrialized countries, growth rates of an order of 3 to 3.5% per year; stable or further declining real interest rates; and no increase in protectionist barriers to debtor country imports. On the side of the developing countries, they include a continuing realistic set of exchange rates to induce adequate export growth; reduction of inflation and interest rates; resumption of private investment; and conversion of the public sector into a positive saver or smaller dissaver. And, even with realization of these conditions, the availability of adequate credit flows to finance current account deficits is a further requirement.

The poorer results correspond to circumstances evoking smaller expansion of debtor exports, larger service payments on the debt, and higher rates of import growth in the developing countries. These correspond to inadequate industrialized country performance as well as policy failure in the developing countries. In the IMF scenarios, the former have much greater consequence than the latter. Poor industrialized country results, including continuing budget deficits in the United States in the same proportion to gross product, can reduce developing country growth from 6.4% to 2.3%; poor developing country policies impose a lesser penalty from 5.7% to 3.7%.

Note that there is a direct trade-off between trade and credit in these calculations. The less capital inflow that is available, the harder debtor countries must strive not only to export but also to restrict imports. Large trade surpluses are an inevitable counterpart to large interest payments uncompensated by new borrowing. There is a conflict between bankers unwilling to lend more and exporters eager to sell more.

There is also a relationship between the rate of growth of developing countries and the credit flows they receive. Inadequate financing, for a given rate of growth of exports, means that lower levels of income must be attained to achieve balance of payments equilibrium. In order to achieve the high case of 5.5% growth developing countries, according to World Bank estimates must be able to count on a current account deficit of $121 billion in 1990; the comparable IMF estimate for its 4.8% scenario is $76 billion in the same year. My own calculations, for a 6 percent real growth of exports and a growth rate of 5 percent, is a still higher $149 billion. It is greater because it is less optimistic on the trade side than the other two.

These estimates make clear that there is a wide range of variation in deciding upon the precise capital requirements, and how sensitive the answer is to underlying trade, and particularly export, assumptions. Optimists tend to emphasize the role of industrialized country growth in limiting the capital requirements through export opportunities. They are clearly right, but only up to a point. There has been a tendency to exaggerate the response of imports from developing countries to the growth rate of the OECD; for the most recent period since 1977, my estimates show that 3% growth in domestic demand of OECD countries yields only about a 2% volume growth in developing countries. In addition, that relationship depends not only upon the level but the composition of OECD growth as the comparison between 1984 and 1985 reveals. They also ignore the role of external credit in making available additional saving to compensate for the large shares of gross product that are being siphoned off to pay interest. Exports can satisfy foreign exchange requirements but do nothing to finance needed investment levels. The exclusive focus on the balance of payments distracts from this potential savings constraint.

Still another aspect of the problem is the potential direction of the capital. The IMF projections show more than half the total developing country current account deficit in Asia, corresponding to continuing rapid trade and product growth. That is, the countries that have no debt problem are projected to receive the additional credit. That will not help the finance starved debtors of Latin America. Aggregates can thus be highly misleading.

The World Bank estimates spell out where the funds required are going to have to come from. What is clear is the pivotal role of private commercial bank credit to any satisfactory outcome. Official capital is presumed to increase in real terms over the next 5 years by only 2.3%. Direct investment fills less than 15% of the gap and grows at 4.2%. The key element is private credit, growing at 5.1% a year in the high case, and at minus 9.5% in the low case.

Up to now, and especially for the most impacted debtors, commercial bank lending has been conforming more to the latter rather than the former level. That behavior has contradicted the optimistic expectations of a rapid return to voluntary lending. You will recall that not too many months ago, after the negotiation of the Mexican multi-year rescheduling, the prediction was that Mexico would be the first country eligible. Quite apart from the earthquake, Mexico was already having difficulty in persuading the banks to put up a needed $2.5 billion owing to deterioration in its balance of payments.

It is easy to see why banks do not want to lend any more. The profit that was available through higher premiums over LIBOR and renegotiation fees for the earlier reschedulings is no longer there. Development prospects for countries can hardly appear bright in the midst of high inflation, low investment and limited growth. On the other side, financial deregulation has turned banks' attention to domestic opportunities.

But that is precisely the weakness of the policy structure that was put in place in 1982. Involuntary lending is all that there is for the debtors, and it is too small to permit a positive adjustment. It is enough to enable countries to get by with minimal rates of growth, and inadequate to support more. What then happens is a credit starved adjustment, incapable of producing improvement in the economy and justifying the lack of creditworthiness to begin with. It is a self-fulfilling prophecy in which countries do poorly and banks are right not to lend. The pity is that an adequate availability of capital would help to produce a favorable dynamic.

Policies

Secretary Baker has just announced a new approach to the debt problem in Seoul. Such renewed attention is highly welcome and shows his increasing sensitivity to the louder and louder rumblings in this hemisphere. The plan responds to several of the issues I have touched upon here. First, it recognizes the importance of renewed growth as a source of political stability as well as economic resources to meet debt service requirements. Secondly, it calls for a more aggressive stance by the World Bank and other regional banks in their lending patterns. Third, it seeks to make the commercial banks an important component of the solution of inadequate capital flow. Fourth, it differentiates the problem of poor African debtors who do not have the means even to pay back the IMF, despite very low debt service ratios, and the situation of the middle income Latin American debtors encumbered by ratios of interest alone to exports of an order of 40 percent.

These features, and perhaps above all, the exercise of U.S. leadership in moving toward a solution, are to be welcomed. An obvious extension will be support for an early increase in the capital of the World Bank to permit it to expand its share of total lending over the medium term. So too is the Administration's emphasis upon maintaining open markets for the exports of the debtor countries to be commended.

The principal questions are whether these new initiatives, as they are fleshed out, will provide adequate relief or sufficiently change the present institutional structure. What has been promised is an increase in U.S. bank lending of $20 billion over the next 3 years, or a positive rate of about 2% instead of the reduction experienced in 1985. But that contribution still constitutes a real reduction of 3 percent through the erosion of inflation. Together with expanded official lending, capital inflows to Latin America will perhaps increase by about $10 billion a year, compared to a present $30 billion net drain of resources. A large part of this additional money will compensate for the lack of anticipated increases in export earnings, rather than represent a full, new infusion. It will thus help prevent still another reversal from external conditions that did not match original expectations. Mexico alone will claim about half, not in order to build the basis for accelerated recovery, but to stay where it is.

Equally problematic is the developing country quid pro quo that is required. What seems behind the offer is a faith in the efficacy of supply side economics in these countries, i.e., a significant reduction in the size of the public sector. While there is a broad, and growing, consensus in these countries that the public sector is bloated, not least because external private capital preferred official auspices, there is less unanimity in favor of extensive privatization of economic activity. The new civilian leadership in these countries are committed to making the' public sector work better, not abolish it. The secret of East Asian success, after all, resides precisely in its developmental state, not alone the particular exchange rate or monetary policies that they follow.

Appeal to private investment as the only way to develop hearkens back to the advice we gave Latin America in the 1950's, leading to an estrangement and disappointment after the close cooperation during World War II. Remember also the adverse effects of the ambiguity in the Alliance for Progress about what proportion of promised funds were official, and what, private. Finally, throughout the region, the Chilean experiment is widely regarded as a failure. This is significant emotional baggage. If the Administration concern extends, as it may, to vetting national legislation for the opportunity it affords foreign investors, such an emphasis may quickly lead to a reaction against what is seen as excessive interference. That would be a pity, precisely because of the growing recognition that the private sector has been deemphasized too much.

Note as well that there is a lurking income distribution problem that insistence upon free markets may also irritate. The consequence of the decline in income in Latin America has been a relatively greater reduction for wages than other forms of income. Indeed, high interest rates have provided favorable incomes to asset holders. The poor look to public policy to ameliorate their situation. They are numerous and they now have the vote. Any development model in the region must have broad based and not merely elite support.

Care should therefore be taken in framing what conditionality requirements are to be imposed lest they be a source of conflict. This is the more so in view of the voluntarism that apparently will continue to apply to the private banks. That has been part of the weakness of the present institutional arrangements, and there are no indications that a better way has yet been found. In the last analysis, the hope is that the banks will be eager to lend in the new environment; the greater likelihood is that they will not, even as they have not up to now. Part of the need is to evolve an adequate post-commercial banking financial structure, rather than continuing to bet on the return of voluntary lending.

In summary, the Seoul initiative should be seen less as a definitive new departure than as a compensation for the disappointing trade and capital flow results in 1985. Many of the fundamental problems remain. Real interest rates remain well above their historical trend and provoke a net outflow of resources. Maturities of loans are too short, with variable interest rates putting the entire risk of variation on the borrower. Some smaller countries face a debt overhang that is simply too large to service. Ironically, while we speak of a case by case approach, terms are not adjusted to the capacities of debtors to pay.

The Seoul initiative is a step in the right direction in bringing together the developing countries and the banks, and in asserting the responsibility of the industrialized countries. In the last analysis, however, its success will be measured by its quantitative impact upon credit flows and the real opportunities for adequate economic recovery it opens to the hard-hit debtor countries.

Conclusion

Resolution of the debt problem is an important part of the international economic agenda. So long as it festers, sustained global economic expansion will be more difficult, and the very fabric of interdependence increasingly strained. We have already seen the consequences of shrinking credit flows upon the free trade regime. In particular, for the United States, as it strives to attain renewed industrial competitiveness, the problem debtors of Latin America are natural markets. In turn, these countries, newly returned to civilian rule in many cases, are a natural bridge to a cooperative relationship with developing countries more generally. The debt crisis, and our emergency response, earned us credit in the region. Putting the problem to rest will earn us more.

Senator **Mathias**. Thank you very much, Professor Fishlow. Before we have any questions I am going to call Ambassador Habib who is very welcome here. He has appeared many times before the Foreign Relations Committee.

I suppose no foreign service officer of the United States has been more honored than he has. Very few, if any, have earned the honors that he has because of his extraordinary service as a diplomat.

So, it is with particular pleasure that I welcome him to this hearing today.

Mr. **Habib**. Thank you very much. Those are very kind words. I could respond in kind at my disappointment at the announcement that someone of your caliber is leaving the Senate. I won't say much more considering that you were once my Senator when I was living in Maryland.

Senator **Mathias**. I will only comment that that is not a unanimous sentiment.

Mr. **Habib**. I think it is a widespread one whether it is unanimous or not.

STATEMENT OF AMBASSADOR PHILIP HABIB, PRESIDENT, WORLD AFFAIRS COUNCIL OF NORTHERN CALIFORNIA

Mr. **Habib**. There is obviously a direct relationship between economic development and political, social, and security developments in the developing countries.

Whether or not one wants to argue that you require political and social stability before you can get economic development or whether you have to have economic development in order to allow political and social stability to flower is irrelevant.

There is no question that the two go hand in hand. There is no question also that from the standpoint of the U.S. national interests it is clear that we have, in terms of our global responsibilities, a direct interest in both the security considerations that derive from economic development as well as the political and social stability that one would hope would exist elsewhere.

Obviously, our foreign policy is based upon, in part, some sense of orderliness in the world, some sense of harmony between nations.

With economic disarray internal problems begin to grow, social problems increase, and the possibilities for gradual political evolution into greater and greater democratic forms will suffer.

With economic disarray comes political disarray. With the absence of economic promise we not only find that you get that kind of internal ferment that it spills over into the international arena very directly.

There is—for want of any better word to describe it—a broad competition between the United States and its allies and the Soviet Union and its allies in the world today.

Some people want to call it confrontation. Some people want to call it conflict. I think that at a minimum we can argue that for the foreseeable future there is going to be global competition.

It is a competition for influence. It is a competition for presence. It is a competition for relations between the super power blocs and the rest of the world. That is not likely to change in the foreseeable future. It certainly isn't likely to change in any planning period that one wants to conceive of at the present time.

Therefore what goes on in terms of social and political stability is related to our capacity to provide the necesssary promise for these developing nations that they will be able to maintain the kind of harmonious relationship with us and our friends in the developed world, and the harmonious relationship within their own regions.

That promise has to be kept there. And it derives very substantially from the economic relations characterized by the north-south relationship.

The south needs markets, the south needs capital finance, and the south needs technology if it is going to develop. By the south I am, of course, describing broadly the developing and underdeveloped nations.

We in the more industrialized areas obviously need markets and resource availability. There are common problems that exist both north and south. But it is most important that the industrialized countries maintain the capacity to be the catalysts for growth in the developing world.

It is important as I have stated earlier—in rather truistic terms—not only for our economic interests but it is important for our political and security interests. There is no question that political changes which have occurred in recent years in Latin America and Africa and to a certain extent in East Asia depend in part on the capacity of governments to provide for the economic well-being of their populations.

In those instances where countries have moved from authoritarian—and sometimes military junta type—governments toward greater and greater political participation or greater emphasis upon the right of the governed to have some say about who governs them in all those cases, there has to be the promise of economic development if these changes are to be sustained or survive.

The consequences of economic failure are usually immediately translated into political instability and create opportunities for those who wish to fish in troubled waters.

Whether or not the current events that we see in Central America or in parts of Africa can simply be attributed to external influence or have some roots in the economic problems that have plagued some of these areas for decades is worth an argument.

But in my opinion it is quite clear that there is more than one cause for instability, there is more than one cause for the hostilities that have arisen in certain parts of the world.

Moreover, I think it is quite clear that if we are to find that degree of orderliness in the world which I characterize as a basic objective of American foreign policy, one way or another that orderliness has to be present in the economic sphere if it is going to be possible to achieve it in the political and security sphere.

At the present time there is a general slump in many of the developing countries. There is a slump to a certain extent in some of the industerialized countries as well. But the slump is more evident in the developing countries.

We have to find a way to bring about a transition to renewed growth in those areas. The industrial countries lead the way—they are the catalyst for worldwide economic progress.

But on the other hand there are certain requirements also in respect to the developing countries themselves. It is generally argued, of course, that by and large there is a great deal of room for economic reform whether in the form of temporary austerity to restructure things that have gotten out of whack, or whether the requirement implies a better distribution of wealth, or whether it implies certain social responsibilities that come with economic growth.

All of these things have to take place in the developing countries. And these factors are basically within the responsibility and authority of each country in itself with whatever assistance it can get from the relationship with the outside world.

Above all, at the present time, I think one has to think in terms of the maintenance of an open trading system if there is going to be the kind of growth in the kind of way that we have emphasized and supported over the years.

This is not the time to withdraw into some kind of neoisolationism on the economic side at the same time that we are trying to talk about greater and greater political harmony and security interests on the noneconomic side of international relations.

If we are to accept some of the statistics that have been put before the committee with respect to differences that would be the consequence of different growth rates, whether you take the low growth rate or the high growth rate—a subject which I was asked to address even briefly—it is quite clear that the low growth rate produces emphasis on protectionism.

It produces spot problems in certain countries. In other words, there are certain countries which will be more drastically affected than others. It also makes the debt problem enormous, which in and of itself creates political and social problems.

If you take the high option—quite obviously which means higher growth and capital movement and open markets—you will still have some spot problems because there are certain places in the world where the capacity to develop lags and it lags substantially.

I think that is particularly true of certain nations in Africa. And I think that is a concern that we have to worry about over the immediate future.

Of course, if you get high growth, then economic reforms become easier and it becomes easier for political reforms to be stabilized. Certainly, of course, the debt problem would be eased.

So, what we are talking about in terms of our own interests, and in some respects of our own economic policies, are monetary fiscal balances, open trading systems, lower and stable interest rates, technology transfer and investment, and reforms as a condition of aid in the low option developing country.

All of these things are directly and intimately related to the political prospects. Let me return in conclusion to what I characterize as the global competition between the Soviet Union and its allies and the United States and its allies.

Whenever disarray occurs—political or economic or where the two go hand in hand—it creates opportunities for those who fish in troubled waters. It creates opportunities for those who argue, and still continue to argue despite the evidences of failure in the past, for a new model for economic development.

For some time we have taken a good deal of satisfaction in the fact that the Soviet model for economic and social development has not been very successful and that it has, in fact, been rejected or at least substantially modified in many countries of the world.

But whenever the economic situation gets out of whack, whenever the political situation begins to deteriorate, either as a consequence or precedent to it, once again you hear the voices that say, well, we have got a better model for you, we have a newer model for you.

And the so-called newer model generally is one which we are all quite familiar with. It operates in Marxist-Leninist and authoritarian terms.

I would argue therefore that if one is to first of all maintain the kind of social order and international order that we seek in the world, if one is to counter the attempts at taking advantage of any disarray for immediate gain, if one is to avoid popularizing the possibility that the Marxist model is the answer to the problems, then one must in effect maintain that degree of interindependence between the industrial economies and the developing economies based upon the necessary adjustments on both sides of the equation.

I think I will stop right there and wait until we get into a freer discussion with you, Mr. Chairman.

Senator **Mathias**. Thank you very much, Mr. Habib. I think with the statement that you have just made and the splendid statement that Professor Fishlow has made, it might be a good point to begin our questioning and conversation.

When former Secretary of State Haig was before this committee for his confirmation hearings and, subsequently, when Secretary of State Schultz was before the committee, both of them made a particular point of the importance—really the dominance of economic issues in international relations.

The general tenor of the message, as I heard it, was that economic issues had assumed an overriding importance in international affairs.

Would you say that is a statement with which you would agree, Professor Fishlow?

Mr. **Fishlow**. The events since those hearings have only confirmed the priority of economic events affecting the relationship between the United States and Europe as well as with the Soviet Union.

Senator **Mathias**. There are a number of obvious reasons that occur but what would you say were some of the dominant ones?

Mr. **Fishlow**. Well, I think very clearly one very important factor in the capacity of the United States to maintain its role of leadership in the world depends upon its own economic growth rate.

It is very obvious that the costs of world leadership involve an expenditure. To the extent the United States is unable to grow, to the extent that the United States cannot count on growth in its European allies, shouldering the burden of defense becomes an intolerable burden that comes back on those economies themselves.

Senator **Mathias**. And will eventually have the effect of depressing the standard of living here if we can't both carry the international burden and grow at the same time?

Mr. **Fishlow**. Well, I think the United States is in the position at the moment of undertaking an international burden without being willing to make the domestic sacrifices necessary.

Basically, the United States' problem is not a budget deficit problem, it is a low savings problem. It is an unwillingness to maintain an internal rate of savings adequate to the range of both investment and other expenditure that are deemed vital.

That is why we are relying on imports of capital from abroad and why the United States is in the position of becoming a net debtor. And that is what seems to be intolerable about the present situation.

Focusing exclusively on the budget deficit problem as though removing it alone would resolve that circumstance seems to me to only go half way toward the underlying difficulty that the United States faces.

Senator **Mathias**. Ambassador Habib has given us the negative side of the same proposition by pointing out that when the economy is in trouble there are opportunities for people who want to disrupt the stability of the world?

Mr. **Habib**. Not only that but whether they want to disrupt the stability of the world to recreate it in an image more sympathetic to their own objectives.

It certainly would open the opportunity to weaken our influence and presence to their net advantage. Let me say, to argue that the economic issue is the primary issue I find that a little difficult.

I think frankly there are a number of primary issues and they all interact. The economic one is not any less important than some of the other issues that we face in terms of the international scene.

I think we have got to presume that of equivalent importance to a certain extent is our capacity to manage our relations with the Soviet Union. They are not going to go away and we are not going to concede.

So, if we think in terms of avoiding the ultimate disaster of outbreaks of hostilities between superpowers, you have got to think in terms of managing that relationship.

I think equally you have got to think in terms of maintaining and strengthening the alliances. I think quite obviously you have got to think of our capacity and our responsibilities for taking care of geopolitical problems as they arise around the world within terms of regional conflicts that threaten to expand into larger and larger areas of danger.

In all of these cases there is, of course, the economic element. There are many other functional problems that derive from economic disarray. But it seems to me that we just can't focus on one aspect of our foreign policy problems.

We have got to take into account the interrelationship between all these problems. And nowhere is it more evident than the interrelationship between political security and economic considerations.

Senator **Mathias**. Mr. Jones.

Mr. **Jones**. Senator, as a businessman two things have literally dumbfounded me about the current goings on in Washington in connection with Albert Fishlow's last point about half the problem is the budget deficit but the other half is inadequate savings, inadequate investment, and inadequate growth.

The two are the following. The Reagan administration appointed John Young, the chairman and CEO of Hewlitt Packard, to chair a very distinguished group of Americans on a Commission on Industrial Competitiveness. They worked for over 1 year on that issue with a good deal of help from Berkeley and Harvard and others.

And at the end reported that international competitiveness of the United States had been declining for the last 20 years and was suffering serious problems of basic Federal Government policy.

They presented their report to Washington. And as everybody knows, it disappeared without a ripple.

Senator **Mathias**. Not an unprecedented occurrence.

Mr. **Jones**. Not an unprecedented one but nonetheless discouraging. And the other thing that I am equally dumbfounded about is Treasury II, the current tax proposals of the administration.

In their discussion and presentation there is never a word about U.S. international competitiveness, the evidence that it has been declining for 20 years. And a number of the proposals in Treasury II and other tax measures by the administration have been anticompetitive, have continued to favor that part of the American economy which does not have to compete abroad, and to discourage savings and investment rather than enhance it.

Senator **Mathias**. With these broad concepts in mind, perhaps we ought to ask this question. What does it matter to the average American whether President Alfonsin succeeds in surviving his debt problems in Argentina?

What does it matter to the average American if President De la Madrid avoids economic disaster in Mexico? Other examples could be given but those are two of the larger ones. Ambassador Habib?

Mr. **Habib**. Well, there would be, of course, a direct relationship to our economic relations with those countries and with the region because it wouldn't be confined to one or the other.

But I will let Mr. Fishlow discuss those in terms of what the economic relationship means to the U.S. economy.

Let me just simply say that in terms of political change and political danger there is no question that the success of an Alfonisin government, the success of the new Brazilian Government, the success and the hopeful capability of the Mexican Government to rearrange its economy, revive itself after this recent disaster, and to restore some economic promise to its own people, these are of direct interest to American security concerns in the hemisphere.

There is no doubt that the record demonstrates that economic and social disarray—and they usually go together. By social disarray I mean political inadequacy, inability to deal with the problems of your people on an individual basis. That is what I mean by social disarray.

The political and social disarray, the security problems that would derive from that would require us to devote a degree of attention and resources to that sort of a problem which in many respects would be wasteful in terms of what is really required.

I would hope that what we are seeing in South America in terms of the political and social changes that have been evident over the last several years is really the wave of the future rather than the return to men on horseback and Blue Sky proposals of how you are going to improve the social condition by some sort of dramatic drastic means.

We have an interest in those areas, a very clear interest. If you want to, you could say it was reflected early on in the Monroe Doctrine. But it is much more apparent in the modern world.

What are you going to do with a Mexico with 100 million Mexicans at the end of the century in which there is political and social disarray as a consequence of economic failure?

It is just incomprehensible that we would face that problem without realizing its seriousness and its direct impact upon our own society.

Well, I could go on but it is quite apparent what I am talking about.

Senator MATHIAS. Professor Fishlow.

Mr. FISHLOW. I would just add one additional consideration. It is not the narrow direct economic consequences of failure to pay. I don't have an apocolyptic vision in which one day these countries will fail to pay and the banking system in the United States——

Senator MATHIAS. I am not thinking of the impact on Chase Manhattan or——

Mr. FISHLOW. Right.

Senator MATHIAS [continuing]. Citicorp. More broadly on what it means?

Mr. FISHLOW. Yeah. But I don't think that is the way it is going to go. I think the impact, in fact, of the current experiment is whether these kinds of countries are going to be part of a postwar system that the United States has pioneered in establishing.

A postwar system involving flows of investment, flows of technology in which these countries have opted to stay in the international market. In which they have opted to try to find a solution by being part of the set of relationships between the industrialized world.

To the extent that they fail at it, to the extent that they withdraw, to the extent that they retreat and seek solutions that are based much more on nationalist models of development, then to a considerable degree what we have lost is an opportunity to reinforce the kinds of global structures that we spent a lot of time since Bretton Woods trying to create.

Senator MATHIAS. Mr. Jones.

Mr. JONES. We have lost $18 billion in exports in the last 3 years to Latin America alone and some 500,000 jobs. That translates directly back into the average American worker.

Senator MATHIAS. What you are saying is that there are half a million Americans who have lost jobs, who don't have jobs today, because of a problem which exists in South America.

Mr. JONES. They are no longer able to buy from us, yes. And they are our largest market. We are selling 40 to 45 percent of our total exports to these developing nations, these debtor nations, particularly Latin America—it is a very important market and a very important source of creating American jobs.

There is one other thing that seems to impact the American worker and their labor union leaders even though Scotty Reston says Americans will do anything for Latin America except read about it.

The one time they read about it is when there is open civil war and insurrection and something going on in another country akin to what went on in Castro Cuba. Central America begins to worry the average American.

When there was urban civil war in Argentina and when Allende governed and then created total chaos in Chile, there are at least some average Americans that think if the continent as a whole got into that kind of trouble again, as it has in the past, that that would be worrisome to them in addition to the loss of jobs.

Mr. **Habib**. The kind of problem you mention is not confined to Latin America. If you look at the most dynamic economic area in the world. East Asia, and you contemplate the possibility that that dynamism will fade because of disruptions in the international trading and market and financial squeeze. I think that once again you reopen the opportunities for difficulties and crises in that part of the world.

We went through a period where the focal point of attention was on the crisis situations, the hostilities in East Asia. Right now that is an area which is relatively—and I use the word relatively advisedly—one of the most stable areas in the world in a political sense.

There are some problems that one can refer to. Just think, for example, what has happened since normalization with China in which China is being brought increasingly into the international economic scene that Professor Fishlow mentioned.

Just think what would happen if that process reverses itself. Just think what would happen in the case of the dynamic economies of Korea, Taiwan, Singapore, and Hong Kong. Increasingly the same is true of places like Indonesia and Thailand.

What would happen if there were to be a turnaround in the sense that they would lose their capacity to function in this market ecomomy which we have developed. And in many respects which we have given them in terms of the promised way to economic and social and political development.

It is quite obvious that what is maybe most apparent in the case of an Argentina or a Brazil or a Mexico is equally relevant in other parts of the world.

Senator **Mathias**. It presents a rather sobering thought when I consider some of the speeches that are made with respect to Japanese trade relations.

Mr. **Habib**. Well, I think one of the things that we have not mentioned is the responsibilities in any specific terms of the other industrialized nations. And it is quite clear that although that has not been the focal point of this hearing at least up until now that that has got to be taken into account.

The demands we are making upon the OECD countries are not only relevant but they are absolutely essential if we aren't to carry the burden all alone. I mean it is just as important for Japan to open its market to the developing countries of East Asia as it is for Japan to open its markets to us in terms of the global economy.

Senator **Mathias**. Now, there are a variety of financial flows that go to debtor countries. There are the results of trade—the payments made in trade, there is commercial bank lending, there is multilateral institution lending.

Professor Fishlow, which of these would you consider more important? You said that private banking credit was pivotal but would you say it was most important?

Mr. **Fishlow**. Well, I think the reason I put a priority on commercial bank lending is twofold. One, if you look at the outstanding volume of commercial bank lending, it is concentrated in the problem debtors—particularly those of Latin America.

Two, because they are the most variable. The range of variability of official lending is within a fairly narrow band. The kinds of other credits that we are speaking about are relatively stable whereas the big unknown in the whole picture is precisely what happens to commercial bank credit.

And because it is such a large part of the total it makes a difference between an adequate availability of credit or a lack of adequate availability of credit.

Senator **Mathias**. Of course, that is threatened at the moment. I know of an actual case in which bank has declined, within recent weeks, to extend a very modest amount of additional credit. They say they are loaned up and that as far as a given foreign country is concerned they are not going to lend another nickel.

Now, what is going to be the impact if that attitude spreads among the 1,500–1,600 American banks that are involved as lenders to developing countries?

Mr. **Fishlow**. Well, I think that attitude has already spread. It explains one of the reasons why Secretary Baker has spent so much effort in recent weeks trying to reverse precisely that view in trying to encourage the banks to change their position by trying to get the largest banks, at least, all to make pledges of increased lending. He hopes to——

Senator **Mathias**. But there is great reluctance. I know of one large east coast bank whose definition of foreign loan was anything that was made as far away as Fairfax, VA.

Mr. **Fishlow**. Yes. Well, here are a whole number of even smaller regional banks scattered through the United States, including some here in the West, that have had their fill of lending to developing countries. Who feel that they have erred in the past and don't want to repeat it.

Senator **Mathias**. But there was an unspoken agreement at the time of the IMF legislation—which I mentioned earlier—that the banks would bear a share of that.

If the Congress approved some replenishment for IMF, that then the banks would understand that they would be expected to expand their credit to debtor nations at the modest rate of 6 percent a year until we got through this very difficult period.

Now, that understanding seems to be breaking down, am I right?

Mr. **Fishlow**. Yes; I think in large measure it held up during the very first phase of involuntary lending but once countries began producing some of these trade surpluses, then the pressure to extend further credits was relaxed and the banks have retreated.

I called attention in my statement to the fact that we are back now to asking the banks to give a positive 2 percent compared to what was taken to be over 5 percent just a few years ago.

I do believe that what we currently see is part of the problem in many of these countries. It does stem from lack of availability of such continuing credit. I am not sure we can avoid banks making decisions on the basis of the realistic opportunities they face.

These are not profitable opportunities that they once seemed to be. And I believe that that is one of the deficiencies of the plan announced by Secretary Baker in Seoul.

Is that what it does is go back to the old understanding and reliance on that kind of voluntarism in circumstances where it really doesn't appear to be rational for it to be forthcoming.

Senator **Mathias**. What is the alternative?

Mr. **Fishlow**. I think the alternative is to try to reduce the flow of interest payments, recognizing that what one sees at the moment is an interest rate that in real terms is substantially above what its historical average has been.

That this puts an enormous burden on the debtor countries which is best evened out by virtue of postponing it over to the distant future. Such an agreement automatically results in a higher volume of lending by such commercial banks to meet some of the credit investment requirements of the debtor countries.

Senator **Mathias**. But with all due respect, I don't think that answers my question because we were talking about the voluntary aspect of this.

Now, if you either extend new credit or lower the interest rate or forego the interest for a period of time, under our economic and political system that has to be a voluntary act.

This is something that is not always understood in the Third World, in the developing world. Ambassadors come to Capitol Hill in great distress, and I am sure under very urgent orders from their government, saying, make your banks lend us this, or, make your banks give us a moratorium on interest.

They have had it explained to them downtown but they get it explained to them again on Capitol Hill, that under our free enterprise system there is no way the U.S. Government can coerce the banks into doing any one of these things.

Now, if Secretary Baker's voluntarism approach is lacking, is there any alternative that you see? Ambassador Habib.

Mr. **Habib**. You reduce the risks, I suppose. But, you know, when you are running the kind of budget deficit that you are, you don't want to increase that budget deficit by——

Senator **Mathias**. Reduce?

Mr. **Habib**. Reduce the risks by some form of guarantees.

Senator **Mathias**. Reduce it to the banks?

Mr. **Habib**. To the banks so that——

Senator **Mathias**. And increase the risk to the Federal Treasury?

Mr. **Habib**. That is where it would impact quite obviously. One of the problems when you run the kind of budgetary deficit—tight fiscal policy that we are up against is that you don't have the flexibility to do these things for short terms.

You don't have contingency funds. You don't have, you know, all of the sort of machinery that we used to ameliorate a sudden or a temporary or what should be a temporary condition.

Senator **Mathias**. Of course that is——

Mr. **Habib**. Now, you can say, well, you can resort to the international funds, that is what they are for. But as you know there isn't enough in the international funds. And by and large they depend on our imputs and the imputs of the other industrialized countries who are all facing the same problem—or not all, but some are.

Another thing you can do, of course, is try and shift some of the burden on other countries. I mean, why do we have to take the whole totality of the burden? I think that is recognized, by the way.

I think the Japanese have been expanding their lending opportunities for undeveloped countries to come to the Japanese financial markets. But I don't think that is particularly true of Europe these days, is it? Mr. Fishlow, you watch those things closely.

Mr. **Fishlow** Well——

Mr. **Habib**. Europeans are sort of turning inward.

Mr. **Fishlow**. Yes. But the reason why so much of the burden falls on the United States is that the particular focus of the current problem is Latin America and there the U.S. banks are certainly the dominant players.

And this was in accord with a position the United States took when Poland and the Eastern European countries were having troubles when it was the German banks that were given the relative lead position.

So, I think that there is some reason why the centrality in this case focuses back on the United States.

I think, Senator, you put your finger precisely on one of the great difficulties. And it is one that I believe is not relevant really in terms of the next 2 years or 3 but into the future—which is where the capital is going to come from.

There is not a great likelihood that it is going to come from the official banks. It is noteworthy that Senator Baker refused to commit himself in Seoul to an expansion of capital of the World Bank at this time.

I think that the simple notion that restoring growth in the developing countries will make the banks eager to lend is really a misunderstanding of the way in which capital markets have worked in the past.

After financial institutions have lost in lending they generally stay away from getting back into the same area for some considerable period of time.

What we have uniquely before us—and I think that is precisely the policy problem—is a situation that used to be handled by writing down the value of the loan. And the way in which the loan used to be written down was automatically. They were bonds that became relatively worthless.

What we have that is different this time in facing the debt crisis is that the loans are made directly by the banks. And if the banks write them down, then the banks' assets become significantly impaired with broader financial consequences.

I think it is the role of policy to understand what is different about the situation this time. And precisely understanding what is different about this time, try to work out a range of accommodation which recognizes the financial fragility of the banking system on the one side, but on the other hand some of the responsibility of the banks to contribute to the solution on the other.

Senator **Mathias**. Before I recognize Peter Jones let me just say that I think we have reached a very important point in these hearings because one of the purposes of the hearings is to look at the importance of his whole question.

Now, I know from experience that the cry in the Congress will be—if we undertake the Habib plan——

Mr. **Habib**. It is not a plan. I just said that was one of the alternatives. Not necessarily that I have thought it through.

Senator **Mathias**. The Habib option. The Habib option. The cry will be in the Congress, you are bailing out the banks again, you are bailing out the banks. And we have faced that before, and we have been able to make the case of the overriding importance of what was at stake.

And we have convinced the majority in Congress that it was a necessary thing to do. That is part of the purpose of his hearing—to examine that issue very precisely.

Mr. **Habib**. You may have to.

Senator **Mathias**. The European record in the past has been reasonably good and within limits we hope it will continue. But, of course, the growth rate in the OECD has not been very helpful.

With their own growth rate so slow they have been unable to devote very much in the way of resources to this problem. Particularly when we are looking to them for 3 percent real growth and defense expenditures and other things.

But with the Japanese I have felt for a long time—it is a personal feeling—that rather than press them for expansion in defense expenditures, we ought to press them for an expansion in their contributions in field of development and security assistance.

Mr. **Habib**. I agree with you completely. I have had that position for a long time. Even when I was in the government I felt that it was not as important for our interests and global interests to press them on the military as it was to get them to relax restrictions and make for more aid or better terms on their economic aid.

Senator **Mathias**. You have to be careful how they are stuctured.

Mr. **Habib**. Frankly, it would solve a lot of problems if we would concentrate more on that than we would on trying to get an increase above the 6 percent rate which has been predicted for Japanese military expenditures.

I think that is a valuable consideration for many reasons, not simply the economic reasons. I think there are certain political considerations that flow from that which I find a little troublesome when we think of any substantial major rearmament in Japan.

I think that the pattern that was laid down in the days when Mr. Ohira was prime minister and which Mr. Nakasone has maintained and tried to increase marginally is quite adequate for the military requirements and our concentration should be on the economic side in total terms.

Now, the Japanese can—and have—pointed to the facilities that they have made available but in many cases they are not on terms

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which are as attractive as they need to be in certain parts of the world.

And in other cases they are concentrated in a few areas where they have very major relationships in terms of resource accessibility. We ought to get them to think more in global terms in that regard. My own feeling is that would be welcome as an alternative to military expansion.

Senator **Mathias**. Yes, I agree the terms——

Mr. **Habib**. That is not a popular point of view in certain circles, as you know, Senator.

Senator **Mathias**. I am well aware——

Mr. **Habib**. The old argument of, you know, why is it that we have to be the military umbrella when they are so prosperous and so on still has a certain attraction, especially when it is used politically and becomes part of political oratory. It is a very attractive line.

It is up to people like you who are prepared to speak out on an issue like that—are speaking out. It doesn't really make much difference, I mean, an occasional private citizen speaking out, it doesn't make a bit of difference.

There has got to be this sense of a dichotomy between economic and military requirements that we impose upon the Japanese.

Mr. **Fishlow**. May I also add though that the capacity to succeed in getting the Japanese to shoulder some of this burden for developing countries depends to some extent on the U.S. domestic policy reducing the requirement of Japanese inflows into the United States so that there is a clear relationship between policies that we follow internally as well as the relationship that we have with Japan on trade policy.

So that the two really are linked together rather than capable of being separated.

Mr. **Habib**. I think we have developed a very good consultative process with the Japanese over the years. There is no inability to talk to each other. In the old days we used to say, well, we don't have the mechanisms for consultative process.

That is no longer true. In the last 10 or 15 years we have developed a very intimate consultative process with the Japanese and we ought to use that to deal with this sort of a problem.

And I think the Japanese would be quite responsive. That is my own feeling.

Senator **Mathias**. I would hope so. Peter Jones.

Mr. **Jones**. Senator, back on your question on congressional reaction to whether the banks are being bailed out again and Al Fishlow's comment that Secretary Baker has not yet committed to a general capital increase to the World Bank and the question whether there will be significant funds coming from these development agencies.

There is a bipartisan executive committee of the Bretton Woods Committee, chaired by Joe Fowler—former Treasury Secretary—and Charlie Walker, that met with Secretary Baker 2 weeks ago just before he left for Seoul.

Secretary Baker made it clear—and it has since been reported in the press—that the administration is favorably inclined toward a general capital increase. And they have now announced targets for the next 3 years of $9-$10 billion coming from these—call it—multi-national banks.

But the reason he hasn't officially committed yet is because he is trying to bail in the private banks rather than bail them out. And his goal of $20 billion-new money from the private banks as a condition to the U.S. Government formally supporting a general capital increase is his strategy for making sure that the banks are bailed in to providing more and doing their share.

That would represent about a 2½ percent annual increase for the next 3 years from these private banks. And I agree with Professor Fishlow. It may well not be enough but if they can pull it off, it will certainly improve the situation over the next 3 years.

Senator **Mathias**. Now, let's go back to the options that Professor Fishlow suggested. What is most helpful to the debtor countries—new financing or a reduction in the cost of carrying the existing loans?

Mr. **Fishlow**. Well, I think from the way in which you asked the question, Senator, it is obvious that if countries were able to get the same quantity of real resources without the future obligation that they would prefer it.

I don't think the countries themselves, however, realistically expect to suddenly be able to face a reduced carrying burden. I think what is key here is the maturity structure of any new loans that are extended.

A new loan that is extended for 5 years is worth a lot less than a new loan that gets extended over 20 years. Over 20 years the cost will partially be eroded by intervening inflation.

And also to the degree that these countries have to become creditworthy, they are going to have to begin paying principal back at some point. And that is going to reduce the burden on them at that time.

I myself do believe that one way of bailing in the banks that would be credible to the Congress would be some condition in which some proportion of interest receipts were, in fact, relent over some long maturity period.

Now, you would call that capitalization of interest. You can call it by any one of a variety of names. It really comes down to the same basic principle, namely, reducing the present resource burden and transferring it to the future in order to permit countries to have more domestic savings available for investment at the present time.

Senator **Mathias**. Both of you have mentioned a danger of interfering with the flow of trade by protectionist measures of some sort or another.

What about this paradoxical problem that the IMF when it goes to deal with a debtor nation almost universally recommends some kind of import restrictions as a condition for the help it is extending to that debtor country so that the domestic workers within the debtor country receive some sort of protection from imports?

But my constituents in Baltimore, MD, who are in the clothing business or who work at a steel mill at Sparrow's Point come to us in the Congress and they say, we want a textile bill, we want a steel bill.

And we say to them, oh, no, we can't give you that because that would create worldwide trade problems. How do we deal with that kind of a paradox?

Mr. **Fishlow**. Well, I think, Senator, strictly speaking, while the IMF have been accused of many things, it really can't be accused of trying to foster protectionism in the developing countries.

The reasons why trade falls is because income falls in those particular countries. And income falls in those particular countries because the only way they can meet their balance of payment situation given the quantity of credit that is available is precisely to strictly limit how much are being spent on merchandise.

That is, of course, the appeal of trying to deal with the question by having adequate credit flows and the importance of enabling countries to grow while they are adjusting rather than forcing the adjustment through a reduction of imports.

As I pointed out, nowhere was this more obvious than in the case of Latin America where imports fell from a level of about $100 billion a year to $60 billion a year between 1981 and 1983.

Under those circumstances there is a clear effect—as Peter Jones has already indicated—on United States exports—where they fell off very dramatically, principally in the case of Mexico.

So, I don't think there is a necessary paradox. And I think in part the new moves that we have seen and the new attitudes that are now present reflect a belief that whatever use such austerity had had in reducing import levels and making the balance of payments get back to an equilibrium level, that it is not a way to continue into the future.

Mr. **Habib**. At times, of course, the restriction that they recommend are based more on doing without things that it would be better to do without. For example, the first place they usually hit are luxury imports and things of that nature.

And it is usually in terms of monetary terms. It is not in terms of particular industry. Although there are times, of course, where the infant industry argument enters into the equation and there is some recognition of the fact that a newly established industry might require some assistance on the imports restriction side for a while.

And that is provided for by many of the international trading arrangements. It is just a question of whether it is justified or not.

Senator **Mathias**. Of course, in all fairness I should add that Jacques D'Larosiere is on the record many times as having said that these restrictions are not due to the hardness of his heart or the inflexibility of the IMF charter but are due to the limitations on his resources.

If he could provide more capital, then, of course, he wouldn't have to ask these things. But at least on the surface—and we deal with perceptions as Phil Habib knows—and the perception is that we are providing protection for these industries which we were denying to our own.

We have talked a little bit about incentives to banks for new lending. We said we might tie it to the new credits the Government would make available. Can you think of any other incentives that we could offer banks?

Mr. **Fishlow**. Well, certainly one of the areas that I am sure will be intensively explored over the next several months is the question of cofinancing and trying to expand actual cofinancing on a project level as well as the question of guarantees.

Certainly it is within the authority of the World Bank to provide such guarantees even though it counts against the capital authorization of the bank.

But I think that what any set of schemes have to recognize is that such incentives should be viewed as a temporary process. I do believe that we should not lock ourselves into a position in which it is assumed that over the long run one can rely on that commercial bank financing for the credit needs of these developing countries.

To some extent it occurred accidently in the context of the 1970's with the recycling of petrodollars. It is an anomaly and intelligent policy over the next several years has to be directed toward easing out of the situation that is really intolerable viewed as a continuing source of development finance.

Mr. **Jones**. One thing on the guarantee that I think is important here. Tom Clausen, retiring president of the World Bank, gets great credit for having pushed through the Reagan administration over its initial opposition the last guarantee that the World Bank has just given to Chile in connection with projects.

And the Bank has only given three. They have done one in Chile, one in Uruguay, and a slightly different variation in Brazil.

If you want to—as Mr. Fishlow says—at least temporarily enhance the flow of private bank lending, in judgment you are going to have to do more of this. And the Clausen success in getting through the Chile guarantee program with the administration was an important first step.

I think for the next 5 years you are going to have to do a great deal more of that and a great deal more cofinancing. Or—as Mr. Fishlow said—the private banks alone in their own short term self-interest simply won't do it in adequate amounts.

Senator **Mathias**. Now, let me just raise a caveat there because in the distant days when I was in law school I remember that there was the general prudent man rule that you had to apply to handling other people's affairs that same degree of care that a reasonable and prudent man would apply to the handling of his own affairs.

Can we encourage the commercial banks to expose themselves further when they are already so broadly exposed? And when those aren't the only exposures—there are other private sector liabilities—very heavy ones.

Is it a prudent and reasonable thing to encourage this further lending to the Third World when we are already as heavily exposed as we are?

Mr. **Jones**. You have scheduled a full discussion of that for tomorrow morning with Robert Heller of the Bank of America in terms of his views.

But my own personal view—again, as a businessman—is if you get some cofinancing and you get some guarantees and some increase in private bank lending, one can argue that they have significantly improved the chances of continued servicing on their existing debt.

And they have lowered their risk of their total package somewhat, particularly if new money is accompanied by a partial guarantee and helps produce greater growth. So, from the point of view of a banker-lender, if this combined package of new voluntary lending plus cofinancing plus some guarantee improve the outlook for their total exposure in those countries—partly because the countries themselves will then be stronger—I think a prudent man argument could be made that it would be a reasonable thing for a bank to do.

Senator MATHIAS. Do you have any——

Mr. FISHLOW. Well, you spoke of paradoxes earlier, Senator. This, of course, is a wonderful example. If everyone lends, then the lending itself becomes prudent. If no one lends, then the lending itself is imprudent.

And I think part of the problem that policies have to be directed toward is precisely determining the adequacy of the total flows that will permit the utilization of the resources in a way that makes it possible for debt service ratios, debt export ratios, debt GDP ratios, in fact, to come down.

I think most of the scenarios that have been constructed do suggest that with some additional credit flow you can, in fact, more likely bring them down than if you maintain strict limitations on the funds that are available.

Senator MATHIAS. I don't want to hold up the next witnesses but there is just one more paradox, one more catch-22 that I would like to discuss with you.

And that is this question. One of our major efforts today is to achieve a more satisfactory ratio in the foreign exchange field and the Plaza Hotel Doctrine—or whatever it has been called—is a sign that the administration is going to be more activist in the field than it has been.

We would hope that as a result of all of the pressures that are applied—not only the Plaza Doctrine but other factors—that there will be a gradual drift down—not a precipitous but a gradual drift downward in the exchange rate of the dollar.

But that is going to have the effect of increasing the costs of imports in the United States, therefore, it may have the consequent result of decreasing demand for imports in the United States and adversely affecting exporters in the developing world.

Is that a concern or is that something that we simply have to accept as we look at this very complex comprehensive picture?

Mr. FISHLOW. I think in making policy it is important not to follow a fourth best policy in order to achieve a desirable objective of maintaining demand for developing country exports. And I think this is a very good example.

Maintaining an artificially overvalued dollar because it contributed to a large set of imports from developing countries as it did last year as a way of contributing to solution of the debt crisis is a bad way of doing it.

It is a bad way of doing it because it has temporary beneficial effects but in the long run cannot be sustained. I think for the countries themselves a gradual decline in the dollar will, in fact, mean some reduction in the cost of their debt because most of it is valued in dollars in any event. So that they will obtain that kind of benefit.

And I think from the standpoint of maintaining an equilibrium among the industrialized countries which is also essential to resolution of the debt problem over the long run that anything that can be done to assure that the dollar continues on its gradual course—which includes some attack on budget deficits and not merely central bank intervention—is a desirable one in the long run from the standpoint of developing countries.

Senator MATHIAS. Is there anything further we ought to discuss under this general heading?

Mr. JONES. I think not.

Mr. HABIB. No, it seems to me you have asked all the right questions. We have tried to give you a range of answers. It is a good beginning for the hearing—as an observer as well as a participant.

I might say, as president of the World Affairs Council, we are delighted that you are holding the hearings in our establishment here.

Senator MATHIAS. With no disrespect to the witnesses or without proper appreciation for your expertise and knowledge, I must say that you haven't made the subject seem any simpler.

Mr. JONES. That is our task for the rest of the hearing.

Senator MATHIAS. Thank you very much.

Mr. HABIB. We may not add to your package of solutions but we may strengthen some of them.

Senator MATHIAS. Well, it has been extremely helpful and I think it will be helpful to the full committee when they read this record and really see the importance and complexity of the issue.

I think we will go right ahead with Professor McKinnon.

Mr. MCKINNON. I think we should call Dr. Heller here.

Senator MATHIAS. Yes, Dr. Heller has been called. Prof. Ronald McKinnon, member of the faculty at Stanford Univerity, and Dr. Robert Heller, Bank of America, will be joining us now and discussing our next item on the agenda which is the OECD nationals' monetary, fiscal, and exchange rate policies.

Which of you gentlemen would like to go forward? Professor McKinnon, would you like to start?

Mr. MCKINNON. Thank you, Senator Mathias.

STATEMENT OF PROF. RONALD McKINNON, STANFORD UNIVERISTY

Mr. MCKINNON. I would like to address what I consider to be the two major problems in the world economy, which is more or less controlled by the OECD countries. What the industrial countries do impinges very strongly on the Third World.

The first problem is the question of monetary reform and what to do about exchange rate misalignments and the great fluctuations in exchange rates among hard-currency countries which provoke protectionism and exacerbate the cycle of inflation and deflation that we have seen in the last dozen years.

The second problem is the banking crisis and the operation of the international capital market. What is wrong with our regulatory control mechanisms which allowed LDC's to go so deeply into debt?

However, we can address the monetary problem without talking about the banking crisis and vice versa. Let me first start with the basic monetary problem among the industrial countries.

I think by now most people agree that the system of floating exchange rates has been unsatisfactory. Exchange rate movements have been very large and without being anticipated. They have led to sharp changes in real international competitiveness without compensating for differential rates of domestic price inflation.

And the great upsurge in protectionism at the present time—having its origin with the overvalued dollar—is simply the most recent manifestation of the rise of protectionist sentiment in a number of countries since floating began in the early 1970's.

If you don't have a stable monetary standard, and relative currency values continue to change arbitrarily, protectionist sentiment tends to take the form of quota protection or NTB's—nontariff barriers. By sealing off your market with quotas, domestic prices are immune from further exchange rate fluctuations. Thus the rise of protectionist sentiment, particularly in the form of nontariff barriers, can be linked to the instability of our currency arrangements.

But the second, less-noticed aspect of the floating rate system has been the cycle of inflation and deflation. Inflation in the 1970's was associated with a depreciating dollar, very high primary commodity prices improving the terms of trade of the less developed countries, and lower—even negative—real interest rates.

And, as Professor Fishlow has described, in the 1970's the less developed countries assumed economic conditions to be normal. In terms that American farmers might use—this was their parity period. And they grossly overborrowed—just as American farmers overborrowed—because the monetary mechanism was essentially throwing out the wrong signals. Then with a change of sentiment back into dollars here in the 1980's, we have not only the rise of the dollar and its overvaluation but we have precipitate worldwide deflation.

It is not just deflation in the United States itself, but deflation worldwide. The sharp fall in primary product prices adversely affected the less developed countries—as did the sharp rise in real interest rates which they must now pay. As with American farmers, the LDC's are in deep trouble—1985 itself provides another example of deflation following an unexpected increase of the dollar in the foreign exchange markets. From the summer of 1984 through to February of 1985, the dollar rose very sharply against other currencies, say, 15 percent, 20 percent. And this was then followed in 1985 by a further fall in primary commodity prices, deflation generally in the world economy, and a slowdown in the U.S. economy.

Now, my view—which I have outlined, perhaps ad nauseum, in a number of places—is that this international cycle can be ameliorated if the American central bank, the Federal Reserve System, uses the dollar exchange rate as the leading indicator for American monetary policy. The Fed should key on the dollar exchange rate.

When the dollar is unduly weak—as it was in the 1970's, the correct response would be to tighten up the U.S. money supply and not devalue. When President Nixon in 1971 found great pressure in the foreign exchange markets against the dollar, he mistakenly decided to slam the gold window shut and devalue. This led to the great price inflation of 1973-74. I consider this to be the beginning of a series of mistakes.

Similarly when President Carter in 1977-78 tried to talk the dollar down, and when the dollar did fall precipitately in 1978 the Fed did not tighten the American money supply soon enough. That was another major mistake in American policy leading to the great inflation of 1979-80.

Then when sentiment changed in favor of the dollar in the early 1980's, the correct response of the Fed—since the international community is now demanding more dollars than had been anticipated—would be to increase the U.S. money supply sufficiently to satisfy that demand and prevent the dollar from being bid up so precipitately. So, it is possible for the Federal Reserve System acting rather quickly to smooth the exchange fluctuations on the one hand, and iron out the international cycle of boom and bust on the other.

This task is made much easier if the Fed coordinates its act with the other principal central banks in the system: The Bundesbank and the Bank of Japan. The three principal central banks can cooperate to stabilize the dollar against both the yen and deutsche mark.

My own rough calculation on this would be the dollar should be the order of 2.2 deutsche marks rather than 2.65 as at the present time. But the yen is not so far away from where it should be. I think the purchasing power parity calculation for the yen would be on the order of 200 to 210 yen to the dollar.

Since the beginning of 1985 the Fed appears to be actually be following an exchange rate rule with which I am delighted. Whatever the reason, U.S. money growth has been very high measured by an M1 standard—unprecedentedly high. And the dollar has come down substantially from its grotesquely overvalued level of February 1985.

But the dollar would have come down a great deal more if the Fed had down two things. First of all, announce that it would continue with rapid monetary expansion as long as the dollar remained overvalued. And second, it secured an agreement with the Bundesbank and the Bank of Japan that they would maintain tight money. That is, simply not expand in parallel during this period when the Fed was expanding.

Then the dollar would come down with very little monetary adjustment being necessary. The expectation effects would be so strong that we would get a better alignment in the foreign exchange markets.

But the Fed is behaving in a more ad hoc fashion, without announcing clearly what are its intentions with respect to the foreign exchanges. Then it takes a lot more monetary pushing to get to the same place as far as the exchange rate is concerned.

All of this is very much linked to events in the Plaza Hotel—to which you referred, Senator. When the new program was announced on September 22, the five central banks all agreed to undertake direct intervention. And they also announced they had agreed to a package of financial measures for the future that would support that direct intervention.

The nature of this mystery package of financial measures is unknown. And it remains unknown. But since the markets believed that this was going to be a substantial package, the effect of the initial intervention was very strong and the dollar fell sharply. Indeed, it continued to fall on days when the central banks were not even intervening so that the expectation effects were very favorable.

But I am afraid this exchange rate realignment will not be sustained unless a new monetary agreement is publicized or announced. The finance ministers should make explicit a monetary program for ensuring that the dollar stays down. That the Fed will continue to be expansionary, and the other two central banks will maintain tight money, for as long as the dollar remains overvalued.

Otherwise, I am afraid the effects of the direct intervention may wash out when the exchange markets come to realize that the emperor really has no clothes after all. There isn't a financial agreement which will support the direct intervention.

Now, to get the dollar down to 2.2 deutsche marks and to 210 yen would benefit the Third World. You mentioned, Senator, that you were concerned that this would reduce our imports somewhat.

But there are two offsetting considerations. One is that most of LDC debt is dollar denominated so, if we can reduce the value of the dollar vis-a-vis yen and deutsche marks where they also sell their goods, this reduces the real indebtedness which they face to some degree.

But we also know that the effect of dollar devaluation will be to raise primary product prices in dollar terms, particularly if this is achieved through expansionary policy by the Fed. And since these are primary product exporters, this rise in price should help them.

But I don't want to claim too much for this policy. I think it is very important to stabilize the world monetary system, iron out the cycle of inflation and deflation and correct the overvalued dollar. That we can do with monetary policy.

But we would be fooling ourselves if we thought that that was going to correct our trade deficit. It won't. As long as the fiscal hemorrhage remains—that the fiscal deficit remains out of control—there is a shortage of savings in the American economy. This shortage of saving will be manifest in a huge trade deficit.

But this deficit will be tolerable from the point of view of our tradeable goods industries because the depreciation of the dollar will reduce the depression and the stress in those economic sectors facing international competition. The tradeable goods industries will operate closer to full capacity and closer to full employment. There will be fewer bankruptcies in the farm sector with the rise in farm prices.

But with the fiscal deficit remaining as it is, and with the American GNP running at a somewhat higher level because of the exchange rate realignment, we will continue to have a trade deficit of the same order of magnitude, maybe a little bit smaller. And this will continue. Of course, the short run effect is somewhat beneficial for less developed countries since they are exporting to us.

But this then brings me to the second big issue: the banking crisis. Even with a monetary stabilization program and appropriate realignment of the yen/dollar and mark/dollar exchange rates the banking crisis will continue. And it is related not only to the position of our own banks in Latin America, but also to the fiscal deficit of the Federal Government.

Because its own finances are in such disarray, the U.S. Federal Government cannot easily intervene to avert a banking crisis at the present time.

Suppose there was a major default by Brazil and Mexico together. To prevent some of the best known names in American banking going bankrupt it would be necessary for the Federal Government to step in and assume all these loans, or guarantee them in some way.

The Federal Government would have to issue new treasury bonds or bills to the banks and assume Brazilian and Mexican loans, which are very dubious assets. So, there would be a big sharp increase in the amount of U.S. Government indebtedness outstanding as a result of this intervention in the financial markets.

Now, nobody would think twice about that if the U.S. budget was balanced to begin with. It would be something that could be easily handled. But suppose we have a sharp discrete increase in indebtedness of the Federal Government, with an increase in the interest payments that have to be serviced because of the intervention to save the banks; and at the same time, we are out of control in terms of the ordinary budgetary expenditures and revenues. Then these will together create a confidence problem regarding the ability of the U.S. Government to meet its interest obligations. An international run on the dollar could follow.

Senator **MATHIAS**. Not to interrupt you but you are talking in terms of magnitude not like anything that we have ever faced in this kind of effort before. The Lockheed or the Chrysler bailouts were very small by comparison to what this one would be. And they weren't easy.

Mr. **MCKINNON**. No, they were not easy. But I think the problem would be quite manageable if we had a fiscal program for balancing the budget as ordinarily defined. And this would have, of course, the incidental advantage of bringing interest rates down in the world and making it easier for the less developed countries to service their existing debt.

So, there is a double advantage from fiscal improvement in the United States. It would make it easier for us to avert a crisis if it did occur, but it would make the crisis less likely because it would reduce the interest rates that the LDC's face.

Consider another point in connection with the treatment of the banks. With Secretary Baker's proposal to get another $20 billion out of the commercial banks into the less developed countries—as you mentioned with your prudent man rule—is hardly the direction the banks would like to go.

And, indeed, the banks are the wrong institutions. Commercial banks who attract mainly short term deposits are really the wrong institutions to be engaged in long term, highly risky, international lending.

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We have a policy dilemma. In the long run we want the banks out of this business all together. It was a bad mistake—a regulatory mistake by the American authorities—to let them undertake highly risky international exposure—particularly in their long term lending.

But the LDC's have an immediate liquidity problem, and the banks are the only institutions sufficiently committed to these countries who can be tapped as sources of capital in the short run. Whence the dilemma.

I think the best strategy would be to use public funds completely for new net lending to the Third World. Secretary Baker should look for public moneys for his extra $20 billion. That would be much better. Then we could begin the process of easing the banks out of a business which they shouldn't be in because it imperils the safety of our own financial system.

In this connection, mobilizing the resources of the World Bank is an excellent idea not only in terms of increasing the capital of the World Bank—which is very important—but to some degree changing the articles in its constitution. As it is presently constituted, any lending that the Bank does must be new net lending for some identifiable incremental project. It turns out that most less developed countries already have too much debt which they cannot feasibly service in the future.

But, nevertheless, insofar as the World Bank steps in, it must be new net lending—in principle. Of course, in practice, such capital is more fundible.

So, I would like to see the articles of the Bank changed to permit refinance. The World Bank could become a long term refinance agency for the more creditworthy LDC's. Maybe I should put that more weakly: those LDC's that agree to some sort of IMF program could get long term refinance from the World Bank. Some of the short term debt of the LDC's would be replaced with long term bond issues.

The World Bank has been very good at tapping capital markets other than our own: using Swiss francs, Japanese yen, and so forth, as a means of finance. This has substantially lowered interest rates charged to LDC's.

So the World Bank's primary role from this point on should be that of a refinance agency—but one which also gives technical advice to LDC's, very valuable technical assistance in specific areas. But the Bank would no longer be a vehicle for massive infusions of new net amounts of capital—which I don't think less developed countries can feasibly pay back.

Now, let me just conclude. I am not quite as pessimistic as Professor Fishlow about the huge volume of capital that is necessary to keep the LDC's afloat. I think he estimated that over $100 billion of new net capital was required.

Instead, let us concentrate on stabilizing the world's monetary machine and aligning the exchange rate system so that the terms of trade of the LDC's are somewhat improved from the present very low level. If, in addition, the United States were to move to fix its own fiscal deficit—which is a prime cause of trouble through high interest rates—the system will survive.

Of course, we will still have to take care of a few crisis cases. However, a lot of LDC's are net savers—like Singapore and Taiwan. Others are net borrowers. Others are not creditworthy—and would have to be given grants rather than loans. All have to be considered on a case by case basis. But if the industrial countries succeed in stabilizing the financial system among themselves, the Third World on the periphery will, on average, do better.

Senator **Mathias**. Thank you very much, Professor McKinnon. I will withhold any questions until after Mr. Heller's statement.

Mr. **Heller**. Thank you very much, Mr. Chairman.

STATEMENT OF H. ROBERT HELLER, DIRECTOR OF INTERNATIONAL ECONOMIC RESEARCH, BANK OF AMERICA

Mr. **Heller**. I am pleased to testify on the monetary, fiscal, and exchange rate policies in the industrialized countries that will help to foster a climate within which U.S. economic growth can be sustained and the Third World debt problems will be eased.

These policies set the framework within which we all have to work. As you, yourself, pointed out this morning, it is important to realize that there is now one world economy and that the same economic events impact the industrialized as well as the developing countries.

I think this interdependence is dramatically illustrated by the plight of the farmers in this country as well as in Latin America. At the same low commodity prices that create economic and financial difficulties for farmers in Iowa and California, in Peru, and in Argentina.

And it is the same global excess capacity in the steel industry that impacts steel manufacturers in Baltimore, Birmingham, and Sao Paulo.

I think it is also important to keep in mind that international financial transactions are part of a general equilibrium framework of broader macroeconomic relationships.

Our current account deficits make other current account surpluses possible. And our budget deficits pull in foreign funds, as has been pointed out before. These relationships are important because they forge a link between the domestic economy of one country and the other economies of the world.

I think we all recognize that excessive Government spending lies at the root of many of our current problems and those of the developing countries. During the last 10 years not a single major industrialized country has run a budget surplus in even one single year.

As long as governments continue to live beyond their means private investments will be lower and private savings and long term economic growth will be retarded. Because U.S. domestic savings fall far short of the financial needs of the United States, we also run a current account deficit of approximately $100 billion, pulling in an equivalent amount of funds from abroad. This amounts now to about 10 percent of all the funds saved in the industrialized countries.

As a general proposition there is nothing wrong with borrowing foreign capital to sustain the high economic growth rate.

But for such a policy to make sense it is necessary that the growth rate in the United States is higher than the interest rate that we will have to pay on the funds borrowed, otherwise we will be worse off as a nation.

With our current nominal economic growth rate of 6 to 7 percent per year even the Treasury itself has to pay interest rates between 7 and 10 percent, thus the wisdom of that policy is very much in doubt.

The developing countries are affected by the U.S. economy in two major ways. For one, the high trade deficits mean that the developing countries have an opportunity to export more goods and services to the United States. This increases their economic growth and allows them to earn money with which to service the external debt. Two, the high U.S. Government deficits result in higher interest rates and thereby higher debt service charges than these countries would otherwise incur. Also, the globally available supply of new capital funds is reduced.

To decide which one of these two effects dominates at the present time is a difficult question. And the answer will also depend on the state of the economy in the developing countries.

As a broad generalization, I believe it is correct to say that the investment opportunities for new capital funds in the debtor countries are quite limited at the present time.

They do simply not need any more new steel mills or copper mines. And consequently, the lack of access to new capital does not present a serious crowding out of LDC borrowers at the present time.

I think we should also keep in mind that there still is considerable capital flight, so that new lending often just turns into a revolving door back into the industrialized countries.

However, the high U.S. import growth rate brought about by the strong expansion of 1983 and 1984 was of very great benefit to the developing countries. But not only the developing countries benefitted from the import boom in the United States.

As a matter of fact, many industrialized countries were in a much better position to supply the commodity mix demanded by U.S. consumers. Among all countries Japan was clearly the one nation that was most ready to fulfill the demands of American consumers, as evidenced by the $40 billion bilateral trade surplus with the United States.

As has been pointed out many times, there is nothing wrong with a bilateral trade surplus as long as the country also goes on to spend the funds somewhere else.

To some extent the other industrialized countries also preempted much of the potential export markets of the developing countries. Also, Japanese consumers and producers did not take the opportunity to purchase more commodities from the developing countries. Instead, they purchased about 20 percent less from Latin America than before and the saved dollars were then reinvested in the industrialized countries.

As a result, the U.S. locomotive stopped pulling the train composed of the other countries of the world. The industrialized countries with their large trade surpluses uncoupled the rest of the world economy from the U.S. locomotive.

Economic activity in the United States was also slowed down because there was no positive feedback on U.S. economic activity from abroad. And the foreign trade multiplier was kept from working because foreign industrialized countries did not import anymore.

For instance, imports by Japan amounted to $124.6 billion in 1980 and to $124.0 billion in 1984. As I pointed out already, the imports from Latin America actually dropped by 20 percent between 1983 and 1985.

Thus, the developing countries did not benefit as much as they would have if the other industrialized countries would have maintained a neutral current account balance—or even been purchasers themselves.

We may conclude that the most immediate policy measure beneficial to the developing world—and also to the United States—would be an aggressive expansion of imports by the other industrialized countries. Japan is clearly positioned best to take the lead on that particular issue.

Over the next 3 to 5 years it is also important to reduce and eventually eliminate the U.S. budget deficit. That will lower U.S. interest rates and reduce the U.S. demand for capital at a time when new capital inflows to the developing countries will be called for.

While the immediate priority of the debtor countries is to put the existing economic resources to work, over the medium term new investments will have to take place to generate new capacity for growth.

Turning to monetary policy, the Federal Reserve has been on a highly expansionistic course since the fall of 1984. The narrow monetary aggregates are growing now at about 15 percent per annum—one of the fast growth rates on record.

Yet, so far, the U.S. economy has been sluggish in responding to the monetary stimulus provided. One reason for that lack of a more positive response by the industrial sector has been the fact that much of the stimulus is being dissipated to other countries.

And as the Federal Reserve pours more liquidity into the U.S. economy, much of that liquidity is used to purchase foreign goods. The high value of the U.S. dollar plays a crucial role here—as Professor McKinnon pointed out—because the overvaluation of the dollar enhances the competitive position of foreign producers.

In that sense, a lower value of the dollar would contribute to global monetary stability. On the other hand, we should also be mindful of the fact that a new inflationary surge would hurt the debtor countries directly because interest rates would rise along with the inflation rate.

In view of the fact that approximately 80 percent of the external liabilities of these countries is based on floating interest rates, the impact of that inflation on the debt service requirements of the LDC's would be immediate.

Only monetary stability can provide a long-term framework for the recovery of the world economy. And attempts by the monetary authority to stimulate spending and production by rapid expansion of the money supply will have only a very transitory stimulative effect.

Mr. Chairman, I think it is clear that proper fiscal, monetary, and exchange rate policies in the industrialized countries can help to create a healthy economic and financial environment within which the developing countries can regain their economic vigor.

The following policies would be particularly helpful in that regard. One, the developing countries would reap most immediate benefit from a rapid expansion of imports by the industrialized countries that are presently in a surplus position on current account.

Japan, which has a current account surplus twice the size of the other industrialized countries combined, is in the best position to take the lead here.

Two, over the next few years the United States should do everything in her power to reduce and eventually eliminate the budget deficit because that would free up financial resources that can then contribute to a renewal of growth in the United States as well as the debtor countries.

Three, steady monetary growth is necessary to provide for a stable financial environment within which the recovery process of the developing countries can take hold.

Four, an exchange rate policy designed to gradually lower the value of the dollar to a more competitive level versus the currencies of the other industrialized countries will help to reduce trade imbalances and, therefore, protectionistic pressures in the United States. Open markets will make it possible for the developing countries to increase their earnings in world markets.

Last, but not least, we should always emphasize that the economic and financial conditions in the industrialized world can only provide the benign environment within which the developing countries can strive to achieve higher economic growth.

In the final analysis, economic progress in the developing world is determined by policies by the developing countries themselves that are conducive to fostering a climate of entrepreneurship and economic growth.

Thank you very much.

Senator **Mathias**. Thank you very much, Dr. Heller. We appreciate your statement and your oral testimony. I would ask the reporter to include both the written statement as well as your oral testimony so we have the full impact of your testimony.

Mr. **Heller**. Thank you.

[Mr. Heller's prepared statement and attachments referred to follow:]

PREPARED STATEMENT OF H. ROBERT HELLER

U.S. Economic Growth and the Third World Debt:
Monetary, Fiscal, and Exchange Rate Policies
of the Industrialized Countries

Mr. Chairman, thank you very much for asking me to testify on the monetary, fiscal, and exchange rate policies in the industrialized countries that will help to foster a climate within which U.S. economic growth will be sustained and the third world debt problems will be eased.

These are important objectives and deserve full and complete examination. Unfortunately, there is no simple magic formula that governments or central banks can follow to assure prosperity for all. Hard work is the only way to achieve that goal.

Fiscal, monetary, and exchange rate policies set the framework within which we all have to work. They determine the environment and thereby the chance of success for the individual efforts to achieve prosperity. Inappropriate governmental policies may well lead to fiscal, monetary, and exchange rate instability and thereby make it much harder for individuals and corporations to prevail in their efforts to improve their welfare.

I would like to begin by underlining the interdependence of the problems facing the world economy. I will then focus on fiscal policies, monetary policies, and exchange rate policies in turn. I will close with an examination of the impact of the policies in the industrialized countries on the debtor nations and draw some general policy conclusions.

1. The Interdependence of the Global Economy

It is important to realize that there is one world economy and that the same economic events impact both the industrialized and the developing countries. This interdependence is dramatically illustrated by the plight of the farmers in this country and in Latin America. The same low commodity prices create economic and financial difficulties for the farmer in California, Iowa, Peru, and Argentina. It is the same global excess capacity for steel production that impacts steel manufacturers and workers in Pittsburgh, Birmingham, and Sao Paulo.

In the absence of direct governmental interference, the "Law of One Price" will assure that commodities around the world will be sold for the same price. This also implies that price changes will impact the various producers of the same commodity around the globe -- regardless of whether these producers are located in so-called industrialized or developing countries. To solve the problems of the industrialized nations means solving the problems of the developing nations.

Viewed from a global perspective, international financial transactions are also part of a general equilibrium framework of macroeconomic relationships. Two facets of these relationships are particularly important for our purposes: the balance of payments identity and the national income identity.

The balance of payments identity assures that there is a global symmetry of current account and capital account transactions. One country's current account surplus has to be another country's current account deficit. Similarly, one country's capital account surplus has to be another country's capital account deficit. On a global basis, the sum of the current accounts as well as the sum of the capital account surpluses and deficits should sum to zero. Caution is advised because sizeable statistical discrepancies distort the data at the present time.

The national income identity assures that the total sources of income in a nation are equal to the total uses of income. That is, total income earned by the residents of a country from consumption, investment, government spending, and export has to be equal to the total income spent on consumption, savings, taxes, and imports.

These relationships are important because they forge a link between the domestic economy of one country and the other economies of the world. Due to the general equilibrium nature of these relationships, any domestic policy action or event that influences consumption, saving, investment, government spending or taxation will also affect the international transactions of that country and by that the economy of other countries. No nation is an island onto itself.

2. Fiscal Policies in the Industrialized Countries

During the last two decades the government sector in the industrialized countries has grown more rapidly than the rest of the economy. While in 1965 governmental expenditures as a percentage of GDP were 30 percent, such expenditures are now very close to 40 percent of GDP. Furthermore, during the last ten years not a single major industrialized country has run a fiscal surplus for even one single year.

As long as governments continue to live beyond their means, private investment will tend to be lower than private saving and long-term economic growth will be retarded. In addition, increased government spending will tend to result in an external deficit, as some of that government spending "spills over" into the international sector. This tendency will be particularly pronounced, if domestic savings are relatively low, so that foreign funds have to be attracted to finance not only the excess government spending, but also the domestic investments that cannot be financed from domestic sources.

The United States government has failed to establish fiscal balance during one of the most rapid economic recoveries on record. This leaves the United States particularly vulnerable in the next recession, when tax revenues will decline and unemployment and social welfare expenditures will rise. This year, the financing requirements of the federal government amount to almost 50 percent of all domestic private saving in the United States. Unless we take action now to reduce the deficit, the financing requirements of the government are likely to rise above the 50 percent mark during the next recession. The resulting high real interest rates will make a recovery even more difficult.

Because U.S. domestic savings fall far short of domestic financing needs, the United States runs a current account of approximately $100 billion at the present time, pulling in an equivalent amount of funds from abroad. This amounts to 10 percent of all the funds saved in the industrialized countries.

As a general proposition, there is nothing wrong with borrowing foreign capital to sustain a high economic growth rate. But for such an economic policy to make sense, it is necessary that the economic growth rate in the United States is higher than the rate of interest that we have to pay on the funds borrowed. Otherwise, the nation will be worse off as a result. With current nominal economic growth of 6 to 7 percent, per annum, and the Treasury itself having to pay interest rates of 7 to 10 percent, the wisdom of this policy is in doubt. Calculations based on real growth and real interest rates lead to similar conclusions.

In the United States itself, the high governmental borrowing requirements and the resulting high interest rates have contributed to a decline in the growth of investment spending this year and a decline in the rate of economic growth.

The developing countries are affected by the state of the U.S. economy in two major ways: for one, the high trade deficits mean that the developing countries have an opportunity to export more goods and services to the United States. This increases their economic growth and allows them to earn money with which to service their external debt. Two, the high U.S. governmental deficits result in higher interest rates and thereby higher debt service charges than they would otherwise incur. Also, the globally available supply of new capital funds is reduced.

To decide which of the two effects dominate at the present time is a difficult question. The answer will also depend on the state of the economy in the developing countries. As a broad generalization, it is probably correct to say that investment opportunities for new capital funds in the debtor nations are quite limited at the present time. There is much excess capacity and the incentive to engage in new investment spending is low. Consequently, the lack of access to new capital does not present a serious "crowding out" of LDC borrowers at the present time.

Instead, strong growth in their export markets will enable the debtor countries to put existing resources to work and to earn the funds with which to service their external debt. The high U.S. import growth rate brought about by the strong expansion of 1983-84 was of great benefit to the developing countries. In the future it is vital that protectionism is resisted and that the developing countries have free and open access to the markets of all industrialized countries.

But not only the developing countries benefitted from the import boom in the United States. As a matter of fact, many industrialized countries were in a better position to supply the commodity mix demanded by U.S. consumers. Among all countries, Japan was clearly the one nation most ready to fulfill the demands of American consumers as evidenced by the $40 billion bilateral trade surplus with the United States.

As has been pointed out many times, there is nothing inherently wrong with a bilateral trade surplus -- as long as the country spends the funds somewhere else. But if one focuses on the relationship between economic performance in the industrialized countries and the debtor nations, two conclusions are inescapable: one, by standing ready to provide the commodities demanded by U.S. consumers, exporters in Japan -- and to an extent also in the other industrial countries -- "preempted" much of the potential export markets for the developing countries. Two, Japanese consumers and producers did not take the opportunity to purchase more commodities from the developing countries. Instead, the dollars earned were saved.

As a result, the U.S. locomotive stopped pulling the train composed of the other countries of the world economy. The industrialized countries with large trade surpluses "uncoupled" the rest of the world economy from the U.S. locomotive.

Economic activity in the United States was also slowed down because there was no positive feedback effect on U.S. economic activity from abroad. The "foreign trade multiplier" was kept from working because foreign industrialized countries, such as Japan, did have marginal propensities to import that were close to zero. For instance, imports by Japan amounted to $124.6 billion in 1980 and to $124.0 in 1984. During the same period, their exports increased from $126.7 billion to $168.3 billion, for a one-third increase. GNP reckoned in yen increased by one-fourth during the same years, but imports remained at their original level.

The economic stimulus that emanated from the U.S. economy during the last three years towards the rest of the world was greatly reduced by Japan and the other industrialized countries. Thus, the developing countries did not benefit as much as they would have if these other industrialized countries would have maintained a neutral current account balance -- or even been stimulative themselves.

We may conclude that the most immediate policy measure beneficial to the developing world -- and also to the United States -- would be an aggressive expansion of imports by the other industrialized countries. Japan, whose current account surplus last year was twice as large as that of all the other industrialized countries (excluding the United States) combined, has to take the lead on this issue.

Having greater access to markets in the industrialized countries is clearly the first priority for the debtor countries. In addition, protectionism must be resisted and existing trade barriers dismantled. It is gratifying that a new round of trade negotiations will start soon under the auspices of GATT. A positive and speedy conclusion of these trade negotiations is vital in restoring growth to the world economy.

However, it should also be recognized that Japan and the other surplus countries did relend their financial funds to the United States. Thereby they kept interest costs here lower than they would otherwise have been. How much this contributed to economic growth in the United States is not easy to ascertain. In any case, if foreign financial institutions had engaged in more direct lending to the developing countries, this would have benefitted these countries more directly. The capacity of U.S. banks to act as an international intermediary is increasingly limited as will be pointed out in my testimony tomorrow.

Over the medium term, say the next three to five years, it is clearly important to reduce and eventually to eliminate the U.S. budget deficit. This will lower interest rates and reduce the U.S. demand for capital at a time when new capital inflows into the developing countries will be called for. While the immediate priority in the debtor countries is to put the existing economic resources to work, over the medium term new investments will have to take place to generate additional capacity for growth.

3. Monetary and Exchange Rate Policies.

The Federal Reserve has been placed into a difficult quandary due to the dualistic nature of the U.S. economy during the last few years. While consumer spending was exceptionally strong and the service sector performed very well, industrial sector growth was much more sluggish. Since the summer of 1984, industrial production has barely increased in the United States. As a broad generalization it is true that all sectors that have to compete with foreign producers have been rather sluggish, while those sectors that are sheltered from foreign competition grew rapidly.

This situation made it very difficult for the Federal Reserve to frame a monetary policy that was appropriate for all sectors of the economy. While this is a demanding task in the best of times, the dualistic nature of the economy made the job even more difficult.

Since the fall of 1984, the Federal Reserve has been on a highly expansionist monetary policy course. The narrow monetary aggregate, M-1, has grown at an annual rate of about 15 percent -- one of the fastest growth rates on record. Yet, so far, the economy has been sluggish in responding to the monetary stimulus provided.

One reason for this lack of a more positive response by the industrial sector has been the fact that much of the stimulus is being dissipated to other countries. As the Federal Reserve pours more liquidity into the U.S. economy, much of that liquidity is used to purchase foreign goods. The high value of the U.S. dollar plays a crucial role here, because it is the overvaluation of the dollar that enhances the competitive position of foreign producers.

If instead of purchasing U.S. government securities in its open market operation, the Federal Reserve were to purchase foreign government securities, the demand for foreign currencies would be directly increased and their value would rise in foreign currency markets. In that fashion, the U.S. dollar would soon reflect more closely the purchasing power of the currency and U.S. competitiveness would be increased. International trade imbalances would be reduced, and the protectionist threat to the developing countries would be lessened.

I would like to make it clear that I am not advocating the establishment of official exchange rate targets. To attain any specified exchange rate target is exceedingly difficult in a world of free capital movements. But the Federal Reserve might use the open market purchases of securities in such a way as to get the strongest possible effect on the exchange rate while pursuing the specified monetary objectives.

It is also a matter of great concern that the Federal Reserve has repeatedly exceeded the monetary growth targets that the Fed itself has specified. If the current policy of monetary growth of about 15 percent per annum is continued, this will eventually lead to a rekindling of the inflationary forces that we fought so hard to eradicate.

A renewed inflationary surge would hurt the debtor countries directly as interest rates would surge along with the inflation rate. In view of the fact that approximately 80 percent of the external liabilities of the major debtor countries is in the form of floating interest debt, the impact of higher interest rates on the debt service requirements of the LDCs would be immediate.

Only monetary stability can provide a long-term framework for the recovery of the world economy. Attempts by the monetary authorities to stimulate spending and production by rapid expansion of the money supply will have only a very transitory stimulative effect. After a short period, financial and economic dislocations will arise. The costs of these dislocations will be much higher than the short-term benefits gained from the monetary expansion.

It should also be recognized that exchange rate changes alone are unlikely to bring about a balanced position in the trade and current account. The exchange rate changes required to accomplish this task would have to be very large, indeed. It will be recalled that in 1979 and 1980, when the U.S. dollar was worth only 1.80 German marks, the United States was running already a trade deficit of $26 and $28 billion dollars. The U.S. dollar will have to fall to extraordinarily low levels before the trade deficit will be rectified by exchange rate changes alone. Cuts in the budget deficit are therefore required to decrease the aggregate absorption of resources, such that the aggregate domestic demand will not continue to "spill over" into the foreign sector.

4. Conclusion

Proper fiscal, monetary, and exchange rate policies in the industrialized countries can help to create a healthy economic and financial environment within which the developing countries can regain their economic vigor. The following policies would be particularly helpful in that regard:

One, the developing countries would reap most immediate benefits from a rapid expansion of imports by the industrial countries that are at present in a current account surplus position. Japan, which has a current account surplus twice the size of the other industrialized countries combined is in the best position to take the lead.

Two, over the next few years, the United States should do everything in her power to reduce and eventually eliminate the budget deficit. This will free up financial resources that can then contribute to a renewal of growth in the United States and the debtor countries.

Three, steady monetary growth is necessary to provide for a stable financial environment, within which the recovery process for the developing countries can take hold.

Four, an exchange rate policy designed to gradually lower the value of the dollar to a more competitive level versus the currencies of the other industrialized countries will help to reduce trade imbalances and protectionist pressures in the United States. Open markets will make it possible for the developing countries to increase their earnings in world markets.

Last, but not least, we should always emphasize that economic and financial conditions in the industrialized countries can only provide a benign environment within which the developing countries can strive to achieve higher growth. In the final analysis, economic progress in the developing world is determined by two factors: hard work and policies by the developing countries themselves that are conducive to fostering a climate of entrepreneurship and economic growth.

Bank of America

H. Robert Heller
Senior Vice President
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International Economic Research

Economics Department

1985 OCT 1 [illegible]

October 11, 1985

Senator Charles McC. Mathias, Jr., Chairman
Sub-Committee on International Economic Policy
United States Senate
Washington, D.C. 20510

Dear Senator Mathias:

It was a great pleasure to participate in the hearings on the international debt situation here in San Francisco.

I hope that the hearings accomplished your objectives and those of the U.S. Senate.

As requested by you, I herewith submit the information on Capital Flight that was recently published by the World Bank in the World Development Report 1985. The enclosed material can be found in that report on pages 64 and 65.

I also enclose the article on "How the IMF Could Revive Trade" that I referred to in my testimony.

I hope that this information is helpful to you.

Cordially,

Robert Heller

HRH/dnw

Enclosures

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Box 4.6 Capital flight in the Southern Cone countries

In the mid-1970s, the Southern Cone countries of Latin America—Argentina, Chile, and Uruguay—introduced major reforms aimed at breaking out of chronically slow growth, fast inflation, and frequent balance of payments crises. By 1978, all had turned around their external accounts and slowed inflation. Chile and Uruguay had also speeded up their growth.

Despite those achievements, inflation in all three countries was still well above its historical average. So in 1978-79, the three governments decided to launch a policy experiment of fixing the exchange rate, with a predetermined path of decreasing small devaluations. They hoped that this strategy, coupled with lower import protection and open financial markets, would quickly cut inflation, improve industrial efficiency, and lower interest rates.

In fact, inflation declined more slowly than anticipated, so real exchange rates appreciated substantially. Uncertainty about policy intentions continued, keeping domestic interest rates high. Attracted by the high yields available on dollar-denominated assets, large amounts of capital flowed into the three countries. These inflows were not regarded initially as a cause for concern because of widespread expectations that foreign borrowing would remain cheap and its supply would be plentiful.

As exchange rates became more overvalued, doubts grew about the sustainability of the exchange rate policy. In Argentina and Uruguay, these doubts were reinforced by mounting fiscal deficits; in Chile by the rapid increase in real wages during a period of shrinking profit margins. In all three countries, many companies incurred losses, while lax lending practices led to the collapse of several large banks. Governments sought to allay fears of devaluation by offering exchange rate guarantees, but these only enhanced the windfalls to be gained from currency speculation. Imports grew at unprecedented rates, while export earnings lagged far behind.

The three countries were able to maintain their exchange rates only by increasing their foreign borrowing. When capital inflows slowed in 1981-82 because of tighter money in the industrial countries and increasing doubts about the three countries' policies, large outflows of capital soon forced large devaluations. The principal legacy of the exchange rate experiment was heavy foreign debt.

Table 4.4 Capital flight and gross capital inflows in selected countries, 1979–82

Country	Capital flight (billions of dollars)[a]	Gross capital inflows (billions of dollars)[b]	Capital flight as a percentage of gross capital inflows
Venezuela	22.0	16.1	136.6
Argentina	19.2	29.5	65.1
Mexico	26.5	55.4	47.8
Uruguay	0.6	2.2	27.3
Portugal	1.8	8.6	20.9
Brazil	3.5	43.9	8.0
Turkey	0.4	7.9	5.1
Korea	0.9	18.7	4.8

a. Data are estimates. Capital flight is defined as the sum of gross capital inflows and the current account deficit, less increases in official foreign reserves. For some countries (notably Argentina and Venezuela), the estimate may overstate capital flight to the extent that unreported imports and normal portfolio investment abroad are included.

b. Defined as the sum of changes in gross foreign debt (public and private) and net foreign direct investment.

Source: World Bank data.

Capital flight cannot be measured directly, but can be roughly estimated as a residual. As the estimates in Table 4.4 show, it was massive in Argentina, Mexico, and Venezuela. Effectively, much of the money being borrowed from abroad was funneled straight out again, thereby not earning returns that could be used to service debt. In such cases, foreign borrowing was a recipe for disaster.

In absolute terms, no country has suffered more from capital flight than Mexico. Mexico traditionally maintained a fixed exchange rate until a devaluation in 1976. In the late 1970s, the rapid growth in public spending and deficits fueled mounting inflation. Once it became clear the government would not reverse its expansionary policies quickly, the exchange rate came under strong pressure. The surge of official borrowing in 1980-81 helped to support the rate for a time, but it was running into waves of capital flight. In August 1982, Mexico was forced to suspend debt service payments, reschedule its debt, and devalue heavily. By somewhat different routes, several other Latin American countries encountered similar exchange rate difficulties (see Box 4.6).

Capital flight has not been confined to Latin America. In the Philippines, the government increased foreign borrowing sharply in 1981, anticipating that exports would soon recover and interest rates fall. The expected upturn in the world economy did not occur. Political uncertainty and lagging economic policy adjustment triggered capital flight. The government eventually had to devalue and reschedule. In Nigeria, official reluctance to devalue the exchange rate during 1981-83, when inflation was running at 20 percent a year, discouraged foreign direct investment, induced substantial capital flight, and encouraged firms to build up larger inventories of imports. Having exhausted its official reserves and borrowing limits, Nigeria built up its arrears on trade credit to $6 billion by the end of 1983.

SOURCE: WORLD DEVELOPMENT REPORT 1985, pages 64-65

SOVEREIGN DEBT

HOW THE IMF COULD REVIVE TRADE

Some countries could export enough to pay their debts, if they could buy raw materials. But that means more debt. The IMF could help.

By Robert Heller

The heavily indebted LDCs need to revive their economic growth so that they can service their external debt. However, lack of access to financial markets now forces many of these countries to curtail their imports of materials vital to the productive process. This vicious circle has to be broken if the debtor countries are to regain their economic and financial health.

As part of the debt rescheduling agreements for many countries, short-term international trade debt was converted into medium-term obligations. By spreading the debt service burden over a five- to nine-year period, the reschedulings eased the immediate cash-flow problems of the countries involved.

However, this sometimes had the unintended consequence of drying up the countries' traditional sources of short-term trade financing. Banks that had established certain country limits for trade financing purposes were suddenly locked into medium-term exposures. In view of their existing debt service problems, banks were unwilling to make additional trade financing available as long as the old debt was still on their books.

Now that recovery is under way, there is an urgent need for new trade financing. There are two possible ways to provide it without increasing the net exposure of the already heavily exposed banks.

Both methods would require an international financial organization, such as the World Bank or the International Monetary Fund, to channel new funds provided by commercial banks to the debtor countries.

One method is for the international organization to serve as a refinancing agency for the existing rescheduled trade debt held by the banks.

Under this plan, the banks would first make a line of credit available to the IMF or the World Bank. The funds would then be used to establish a trade refinancing facility, modelled after the IMF's trust fund or the IMF oil facilities of the 1970s.

Then the international organization would use the line of credit to purchase the existing trade debt from the banks. Finally, as an integral part of the plan, the banks would agree to make an equivalent amount of new trade financing available to the countries involved.

An alternative method would also involve, as a first step, the provision of a line of credit by the banks to the IMF or the World Bank. The IMF or World Bank would then use the funds to establish a trade discounting facility.

Banks would then be empowered to grant new trade credits to countries participating in IMF or World Bank-sponsored adjustment programmes.

Finally, the banks would have the opportunity to discount the new trade paper at the IMF or World Bank. The banks would thus pass the new trade debt on to the IMF or World Bank, which would use the funds provided originally by the banks to finance the new trade debt.

These two plans are similar, in that they rely entirely on bank funds to provide new trade financing to the debtor countries. The international organization does not have to provide any funds of its own. No new government funds would be involved.

The two plans differ in that, under the trade refinancing facility, the IMF or World Bank would wind up holding the old, restructured five- to nine-year loans, while the banks would acquire new short-term trade-related assets.

Under the trade discount facility, the banks would retain the old, restructured trade credit on their books, and would serve as an originator of new short-term trade-related obligations that would eventually be sold to the IMF or the World Bank.

In either case, an IMF standby arrangement or a World Bank structural adjustment programme should be a prerequisite for participation in the new trade financing facility. This would ensure that the debtor country is following appropriate adjustment policies and that the funds are properly used.

The government of the borrowing country should guarantee the newly originated trade paper, because the IMF and the World Bank do not as a rule lend directly to private entities. If the government should be unwilling to take on all the credit risk, it might guarantee only the availability of foreign exchange. In that case, the banks would assume the credit risk of the loans that they originated. That is, if an individual borrower went bankrupt, the IMF or World Bank would have recourse to the bank that originated the loan.

Pricing is clearly an important issue. In the case of the trade discounting facility, the banks originating the new trade paper would earn only a modest origination fee, say one eighth or one quarter of a percentage point. The line of credit to the World Bank or IMF might carry a spread in the neighbourhood of ⅜ or ½% over Libor. Depending upon the charges imposed by the World Bank or IMF, the final interest rate cost to the borrower might be about 1% over Libor.

Can the IMF, under managing director Jacques de Larosière, now help the LDCs recover with new trade financing?

Pricing under the trade refinancing facility might be more complicated, as the IMF or World Bank would acquire the original loan, with a spread of perhaps 150 or 250 basis points over Libor. Either these spreads could be reduced to the rate charged by the banks for the credit line to the international organization, plus a small spread for the IMF or World Bank; or the IMF/World Bank could establish an interest-subsidy account that could be used to channel some of the earnings back to the debtor countries.

Should it be the IMF or the World Bank which administers the facility? The IMF has administered special facilities, such as the oil facility, and its compensatory financing facility is trade-related. The World Bank is very intimately concerned with the micro-economic aspects of a country's performance, and several of its structural assistance programmes have focused on the international trade sector.

Both the IMF and the World Bank would be well suited to carry out either facility for the benefit of developing countries in need of new trade financing. Exporters in the industrialized countries would benefit by the growth of their export markets. The increased international financial stability would also benefit the world financial community and make it possible to provide the additional funds required for a rejuvenation of world trade and economic growth in the developing countries. □

Robert Heller is senior vice president and director, international economic research, Bank of America, San Francisco.

Senator **Mathias**. Before we get to general questions, let me ask each of you a couple of questions which arise from your statements.

Professor McKinnon, would you, just for the record, define what you mean by monetary expansion?

Mr. **McKinnon**. A rapid rate of increase in the money supply, Senator Mathias. But as long as the dollar remains overvalued we can undertake that without inflationary consequences. You can have a rapid increase in the money supply as long as the demand for money is high. And I think the exchange rate is a good signal when the demand is high. And therefore we can put up with rapid money growth.

Senator **Mathias**. Do you foresee a time when we might have to see a contraction as the exchange rate is stabilized?

Mr. **McKinnon**. Yes. Suppose the group of five coming out of the Plaza Hotel meeting actually succeeded in changing expectations sharply in the exchange market so that there was a run on the dollar, which is not inconceivable. Or, a banking crisis could provoke such a run. It would then be necessary for the Fed to step in and tighten money, maybe quite sharply, in order to stabilize the exchange rate.

Senator **Mathias**. One other question—you violated one of the articles of faith when you said that the yen and the dollar were very close to where they ought to be in your judgment——

Mr. **McKinnon**. Yes, in the neighborhood of 210 yen per dollar.

Senator **Mathias** [continuing]. Because one of the assumptions is that our enormous trade deficit with Japan is in large measure the result of dislocations in the exchange rate of the dollar? You want to expand on that a little bit?

Mr. **McKinnon**. Yes. There is a crucial analytical distinction between the overvalued dollar and our trade deficit which is not made in public debate.

People see a chain of causation that goes like this. There is a large U.S. fiscal deficit which bids up interest rates in this country and attracts capital from abroad. This bids up the dollar in the foreign exchange markets and makes our exports uncompetitive and encourages imports. Therefore, if we correct the dollar overvaluation, somehow we will reduce or eliminate the American trade deficit according to conventional thinking.

My point of view is somewhat different. I think it is very important to eliminate the dollar overvaluation through monetary coordination. And by doing so we will reduce the economic distress in our tradeable goods industries. Across the board, we will raise their terms of trade.

But suppose there is no fiscal improvement. Then continue to run a large trade deficit which is merely a reflection of our fiscal deficit, no matter how exchange rates are adjusted. What the fiscal deficit does is destroy saving—the capacity of the economy to save—and pushes our expenditures above our income. And that will inevitably spill over into the balance of payments in the form of a large current account deficit.

So, when the group of five sits down to work out an exchange rate arrangement—which I hope they do—they should not specify a certain target for the American trade deficit. Rather, they should specify exchange rates in terms of purchasing power parity. But the trade deficit will continue as long as we do nothing about the fiscal deficit.

Senator MATHIAS. Well, that leads me to a question for Mr. Heller because the second of your recommendations was that the United States should do everything in her power to reduce and eventually eliminate budget deficit.

I am going to ask you a question that may sound somewhat strange, but I think it is important to be understood.

The Congress is working. They were up to 3 in the morning last night and this morning dealing with this problem. There is widespread recognition of it in many circles in the United States.

But is the banking industry committed to this view?

Mr. HELLER. Yes, very much so.

Senator MATHIAS. You really think there is a commitment?

Mr. HELLER. Yes.

Senator MATHIAS. Then why are we having such trouble in bringing the administration to this view?

Mr. HELLER. I think the administration also has the view that the budget deficit should be reduced. The problem——

Senator MATHIAS. If you do it without raising taxes and if you do it without various other things?

Mr. HELLER. Yes. That would clearly be the preferable course of action—to reduce expenditures rather than increase spending.

During the last 2 years U.S. Government spending has already increased at double the rate of GNP increases. To increase the rate of Government spending even further would be harmful. As you know, it is a very high rate of Government spending that we do have at the present time. And it is important to get the rate of spending down rather than increase taxation.

As we increase the burden of taxation on the American producers we will also make the American industry less competitive internationally. So, it will all feed back in the process.

Senator MATHIAS. Now, another statement that you made was that you were not advocating the establishment of official exchange rate targets. And that rang somewhat sympathetically on my ear.

But, do you think even for a limited period of time that kind of control is a useful and desirable exercise?

Mr. HELLER. I don't think that you can achieve exchange rate stability in a world of free international capital movements. And you have to have free international capital movements in order to keep the world economy functioning.

Like we said before—it is one global economy. And to erect artificial barriers against the flow of resources from one country to another where everything would have to be approved first by some government bureaucracy, presumably, that would be a very, very difficult world to live in, indeed.

International trade and free international capital movements lead to more efficient allocation of resources. And, therefore, they will bring about a higher growth rate.

To have fixed exchange rates in a world of international capital movements will be difficult where we have enormous volumes of foreign exchange crossing markets every single day. It is beyond the power of central banks to intervene and to keep to these exchange rate targets. And once you have specified a target and the private markets see an opportunity to bring the monetary authorities away from these targets, then you would get the destabilizing speculative flows that we all fear.

We have learned very well in the 1960's and the early 1970's that we were not able to stick to these exchange rate targets. And, therefore, today it would be even more difficult to do so.

Senator **Mathias**. Let me just follow up with one question. Then you really come back to your recommendation of a reduction of the budget deficit as a major element?

Mr. **Heller**. That is right. The reduction of the budget deficit is a very important element. And I think it is good also for the domestic economic health in the United States because we will not be able to live with a $200 billion deficit, ad infinitum.

As the pains of Congress that you were talking about show—as these pains very clearly show. And it is a drain on the resources of the rest of the world.

Senator **Mathias**. Mr. Jones.

Mr. **Jones**. Could I pursue for another minute your question to Professor McKinnon on the conventional wisdom that if the dollar comes down our trade deficit is substantially reduced?

I think Fred Bergsten and his people are estimating that two-thirds of the problem would be substantially eased.

Senator **Mathias**. And that is reflected in the industry groups?

Mr. **Jones**. Yes.

Senator **Mathias**. I talked with officials of General Motors, Chrysler, and Ford, and I said, on a scale of 10, what part of your problem do you assign to exchange rates. And they were unanimous in saying, at least 5.

I talked to some steel executives and they would put it somewhat higher than 5. So, this is widely perceived, not only within Government.

Mr. **Jones**. And it sounded like a contradiction in terms. It sounded like what you were saying was if the dollar comes down, there will be substantial easing of the burdens on American manufacturing?

Mr. **McKinnon**. Yes.

Mr. **Jones**. There will be fewer bankruptcies. You say they will do a lot better but there will be very little reduction in the trade deficit.

I don't see how you can have both those things at the same time. We need elaboration.

Mr. **McKinnon**. OK. Well, I presumed that the fiscal deficit remained unchanged. And the only thing we did was modify monetary policy so as to bring the dollar down. And that is quite possible despite what Mr. Heller says about free international capital flows. As a matter of fact, the bigger the capital flows are, the more effective monetary policy becomes in influencing the exchange rate.

Senator **Mathias**. You are assuming an annual deficit of $200 billion a year?

Mr. **McKinnon**. I don't like it, Senator. But what I am trying to do is——

Senator **Mathias**. Well, I must say, on the basis of the track record that you can't be said to be totally illogical in making that assumption.

Mr. **McKinnon**. All right. But let's assume that we don't fix the fiscal deficit, but we do operate on exchange rates. We do as the group of five has done—bring the dollar down substantially—perhaps even further against European currencies. My goal would be 2.2 deutsche mark per dollar.

Now, what can we expect out of that in terms of its impact on the American economy? Well, the currently depressed areas in the American economy—farming, unprotected manufacturing activities, mining—will revive. As the price of tradeable goods rises, the distress in these activities will be relieved. So, their output will be higher.

Now, if that was the only thing that changed, our trade deficit should be reduced—your point. But with the output of these currently depressed industries running higher, our GNP will run at a substantially higher rate. And that effect by itself will pull in more imports.

Because we have a positive propensity to import, there are two offsetting effects. On the one hand, the depreciated dollar makes our manufacturers in foreign products more competitive in world markets. On the other hand, our GNP will run at a higher level and our demand for imports will be higher. So, thus, I do not expect a big net effect. Maybe the dollar devaluation will improve the American trade deficit somewhat. And it——

Mr. **Jones**. Where will those new imports go—in what sections?

Mr. **McKinnon**. Well, with the American GNP running at a higher level we will have imports coming in broadly across the board but in excess of our own capacity to produce those goods. Our absorption level will remain very high because the Federal Government is running such a big deficit. As long as that continues there is no way we are really going to bring down the trade deficit substantially. It is best not to have false expectations about what an exchange rate change by itself would do in these circumstances.

Senator **Mathias**. Mr. Heller.

Mr. **Heller**. I think Professor McKinnon has said it very well. Let me just add one thought here. In 1979 and 1980 we had the exchange rate of 1.8 deutsche mark against the dollar—one mark eighty.

And at that time the United States was running already a trade deficit—if I recall correctly—of $26 billion in 1979 and $28 billion in 1980. So, you see that the exchange rate alone can clearly not do the job.

Senator **Mathias**. Well, this is an important point because if you are right, then a great many people in Washington have been laboring under a misapprehension.

Mr. **Heller**. But let me emphasize again, the individual auto manufacturer, the individual steel mill will become more competitive in world markets. And pressures from foreigners coming into the country will be reduced.

The second point that Professor McKinnon said is also worth bearing in mind. Your whole GNP—because of these additional exports that the United States will have—our GNP will grow.

And then, as the U.S. economy grows, we start to pull in more imports. I think the individual manufacturer will still be right because he will see more exports and he will see some reduction in pressures on market share from imports. But the——

Mr. JONES. I think he said we would be operating at close to full capacity—of our own capacity before these imports come in which means unemployment would be reduced and growth would be higher.

And if you had higher growth and full utilization of existing capacity, then your ability to import without the political protectionist consequences we are currently seeing would at least be somewhat better.

Senator MATHIAS. But what about commodities that are in direct competition? Let's say, Brazilian steel as against American steel—as the exchange rate alters Brazilian steel becomes more expensive, will there be a resort to the utilization of domestic steel? And steel is an industry which we have an enormous idle capacity at the moment.

Mr. MCKINNON. Well, the depreciation of the dollar through monetary expansion by the Fed will cause the American economy to run at a higher level of activity—and so will the world economy become more buoyant because the spillover effects are so high.

So, this means that the worldwide demand for steel would be greater, Senator. Therefore, the competition will be less ferocious in any one market. But the steel industry is particularly depressed and it is difficult to predict what would happen. I am not claiming the problems of the steel industry are going to be fixed because the dollar's value changes by 20 or 25 percent. But some of the downward pressure will be relaxed.

Those American industries which don't have long term problems with retrenchment—like in Silicon valley—will clearly be better off. At the present time, even the semiconductor, and computer industries—are depressed by the overvalued dollar.

Senator MATHIAS. Would an improved coordination with respect to economic policy in one of the OECD countries be—No. 1, would they be helpful—No. 2, would that be enough in itself to deal with this problem?

Mr. MCKINNON. We want to separate monetary and fiscal policy. I think that with proper monetary coordination among the OECD countries exchange rates can be stabilized even though capital flows are huge. Proper monetary coordination would impose the same basic monetary policy on all the participating countries so that they evolve toward the same basic rate of inflation.

Senator MATHIAS. But that requires more coordination than they presently——

Mr. MCKINNON. Yes.

Senator MATHIAS [continuing]. Exercise?

Mr. MCKINNON. It means the mystery package that was promised at the Plaza Hotel has to be unveiled. The three principal central banks must get together and cooperate. Otherwise, their success in the exchange markets will just peter out. I think that the monetary problem could be settled separately. However, that still leaves the question of the international coordination fiscal policies which bothers both Mr. Heller and myself. It is not really a good idea to push the Japanese and Europeans into running larger fiscal deficits so that they will import more and reduce their net trade surpluses. We have too great a saving deficiency in our own economy because of our, huge fiscal deficit. We rely on foreigners to finance our corporate and housing investments. This transfer of saving from them to us is embedded in their current account surpluses and in our current account deficits.

If we push them—as the administration seemed to say—into cutting their tax revenues or maybe even raising the social expenditure infrastructure in Japan, this will reduce their net savings rate. World interest rates will go up and that will have an adverse effect on the Third World.

So, from the fiscal side, I would say the problem is strictly getting the U.S. deficit down or eliminating it, not pushing the others into running fiscal deficits. Then when that occurs, and the exchange rate regime is stabilized, the trade problem will take care of itself.

Senator MATHIAS. Did you want to comment on that, Mr. Heller?

Mr. HELLER. Actually, I think we don't even differ in the long term monetary policies that are appropriate. If I heard Professor McKinnon correctly, he said that the best purpose is served by having stable monetary growth rates that are roughly equivalent in the industrialized countries. So, say 4 or 5 percent per annum or something in that general neighborhood.

I think where we differ is that at the present time we see monetary growth rates of 14 or 15 percent, yet we still see an overvalued dollar at the current time. And I hope I am not misinterpreting you that you argued that you should expand monetary growth even faster than 15 percent to get eventually to the 5 percent.

I would say let's cut down on monetary growth and let the market take care of the exchange rate swings. Sooner or later we will get a rough stability in the markets in the longer term and I hope we won't all be dead by that time.

Senator MATHIAS. Of course, the problem of the reduction of the Federal budget deficit is a continuing one and requires the wisdom of the whole country. The Congress has already cut social expenditures—just for one example—to more than offset the cost in the increase of defense expenditures.

The defense expenditures are not directly impacting on the budget deficit because they have been offset by—more than offset by social expenditures. Now, how much further you can go down this road is a political problem in the broad sense, not in the narrow election sense, but in the broad sense.

How much more can you do? How much more should you do? I personally felt that you should not submit to "debtmail"—to using the debt as a political instrument to curtail necessary expenditures—and finding that balance and finding the point at which you have to resort to new revenues is a very difficult subject and one that we really need the best thinking of the country on.

And we need a broad expression from the public as to whether they want to pay for Government services and therefore pay more taxes or do without Government services and pay less taxes.

That becomes an ultimate kind of political question in a democrary. But let's move on to the question—which is very clear from your testimony—that we are highly interdependent now with the rest of the world.

What happens in the Third World and the other industrialized nations is going to impact in the United States, notwithstanding the enormous size of our economy. Are we too interdependent? Is retreat either possible or desirable? Who wants to tackle that?

Mr. **McKinnon**. Well, Senator, if we had a stable monetary standard under which we can trade freely, then I think we can take almost any degree of interdependence.

In contrast, if we have a monetary standard which continually fluctuates so investments made at one set of exchange rates become obsolete when we get a new set of exchange rates, then interdependence has its unsatisfactory aspects.

So, I think the monetary issue is of paramount importance. But then the banking crisis obviously originated because we didn't impose the same rules of prudence and caution on our commercial banks international activities that we tried to impose on what they could lend domestically. The Eurocurrency market in the 1970's was an unregulated window through which the banks could do virtually anything, and they did.

So, we should reconsider how we want our financial institutions to be regulated in terms of prudence in balancing domestic and international activities. But having done that, then I see no harm in increasing interdependence.

Senator **Mathias**. All right.

Mr. **Jones**. From the point of view of U.S. business actual practice, I see a lot of response to what Professor McKinnon just said.

My former company, Levi Strauss, and a number of others have looked at these exchange rate swings even more than formal protectionism and decided the only way to operate overseas is to attempt to achieve self-sufficiency within any one large market. And we did not attempt to either export from or import to these major foreign markets.

But because of these unbelievable swings in exchange rates, as well as formal protectionism, every time you turned around you were being hit another way. And so it was less interdependent in that sense.

Mr. **Heller**. I think that nobody would want to go back to increased barriers. When we talk about the United States itself, for instance, we wouldn't want to erect trade barriers in California against the other 49 States.

The same basic principle applies on a global basis. Yes, there are the monetary swings but, basically, you want to work toward a more integrated world economy because that brings about the greater efficiency.

And cutting yourself off from that world economy like some countries have done—for instance, Cuba—shows that, you know, you have a much, much harder time to make progress.

Senator **Mathias**. Where would you assign the kind of problem which sometimes emerges when we undertake an economic program for political reasons—or when we fail to do it?

On the failure side, where we have drawn back from at least tentative commitments to fund international financial institutions for domestic, political reasons?

Or where we have engaged in some kind of economic support program with a country which has rather hopeless economic problems—at least hopeless against the scale of help we are offering—but we offer it because of political incentives?

Now, does good politics make for bad economics? How do you deal with that?

Mr. **McKinnon**. I personally, Senator, would make a distinction between grants and loans. So, if we want to prop up the Sudan—as we did until the most recent change in Government—the U.S. Government should simply give them money. The Sudan is hardly creditworthy by most standards. Then any aid the United States gives to the Sudan should be an outright grant and not—quote—something that has to be paid back.

Senator **Mathias**. Don't kid ourselves?

Mr. **McKinnon**. Don't kid ourselves, that is right. Keep separate our regular commercial activities which are on a quid pro quo basis of lending and borrowing.

Our foreign policy should not push commercially oriented institutions into making political loans in certain circumstances

For Secretary Baker to get the banks to extend another $20 billion is in this category. In fact, I think there is a case for getting another $20 billion into these countries but it should be assumed publicly rather than pushing these private commercial organizations further into a hole.

Senator **Mathias**. Any of the rest of you want to comment on that question?

Mr. **Heller**. Well, I will be talking on that specific topic tomorrow as well. But I think, the U.S. Government has to be in there in these broader packages.

We are talking about a three-legged stool here. We are talking about reform in the debtor countries. We are talking about more money from the banks. We are talking about more international organizations in there.

But where is the U.S. Government besides bringing the three parties together? We would be much more comfortable if the U.S. Government would be the fourth leg on that stool and through the Export-Import Bank or other organizations help to bring about a solution.

Senator **Mathias**. Not to anticipate tomorrow too much but let me just ask this. Does bringing in the bilateral political considerations weaken the effect or the efforts of the multilateral agencies?

Does it make it harder for them to set reasonable conditions? Make it harder for the private sector to come in with some expectation of profit?

Mr. **Heller**. Well, I think there are very, very many broad aspects to your question. Let me just touch on a few of them.

First of all, it is clearly in the political interest that we do things on a bilateral basis and support governments bilaterally if it is in our security or political interest in a global strategy.

Second, I think——

Senator **Mathias**. But that is our business?

Mr. **Heller**. That is our business. And we can do it and Congress can take care of it and we say, OK, we have got friends in country X and we are going to support them with direct payments.

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It is much more difficult to do it through the commercial banking system, like Professor McKinnon has very correctly said. I think the other thing that we do a lot in this country is to try to make policy by imposing restrictions on the U.S. business and their ability to function abroad.

You know, it is very, very difficult for American businessmen to work through the whole maze of regulations that range from the Foreign Corrupt Practices Act all the way to reporting requirements and things of that sort. I am sure Peter Jones would be able to sing you those litanies a lot more than I am able to do.

But the temptation to make foreign policy by imposing restrictions on U.S. business I think should be resisted.

Senator Mathias. Since you are speaking directly to the Congress. I might as well ask you this question.

What about the attempt the Congress occasionally indulges in to control the decisions made by multilateral institutions, say the Inter-American Development Bank, whereby we instruct the American representative to threaten that if they lend $1 to the Sandanistas, for example, that all further credit to the bank will be suspended? That kind of thing.

Mr. Heller. Well, I think we have got to remember that we are shareholders in those institutions. We are shareholders maybe to the extent of 20 percent, or something in that range.

There is nothing wrong with the United States leading or shaping the general lending policies of these institutions. But I think we should stay away from interference in individual credit decisions that are being made by the World Bank or the Inter-American Development Bank.

Either we are a part of these organization or we are not. And, therefore, if we are part of an international multilateral organization, we just got to have confidence that it is in our broad, long term interest to be part of that organization. And we have to resist the temptation to dictate policy on each and every individual loan decision that is made.

I am trying to make a distinction between loan policy and actual transaction decisions. And we should stay out of the latter and we should be very much involved in the former.

Senator Mathias. Well, I tend to agree with that. We will see if we can give broader currency to that view when we publish this record in Washington.

I have one final question that bears on the whole issue here. And that is the net debtor status of the United States. President Reagan has given his personal definition of what it means.

I think there has been a more than passing interest on the part of the American people what it means to once again for the first time since 1913 to be a net debtor nation.

The question of when we became a net debtor nation is not altogether certain. Jacques D'Larosiere felt that we had crossed that line last December. A more general view, I think, is that it has been some time during the past summer.

The lights didn't grow dim at that moment. The electricity wasn't cut off or the water wasn't cut off. But now it seems to be generally agreed that we have crossed that line.

What is the real import of it? What does it mean to the average American that they now live in a Nation which is a net debtor?

Mr. **Heller**. If I may start on the topic. It doesn't make much of a difference whether you are a net debtor or net surplus Nation to the tune of a few billion dollars one way or the other.

Your former colleague, Senator Dirksen, was fond of saying, as you know, a billion here and a billion there, and pretty soon you are talking real money. And the magnitude we are talking about is not a billion here and a billion there, but pretty soon it is going to be a trillion here and a trillion there.

Senator **Mathias**. With an annual net account debt of $100 billion or so, why it is going to mount up.

Mr. **Heller**. In about 5 to 6 years we will be—with the accumulated interest that is due on those amounts—we will be a net debtor to the tune of about $1 trillion by the end of 1990—which isn't all that far away.

By that time, I would argue, yes, it will be a big burden on the U.S. economy because then we have to run a trade surplus of $100 billion just in order to pay the interest that is due on that outstanding debt, if you figure a 10-percent interest rate on that $1 trillion.

So, that will become increasingly a very heavy burden on the U.S. economy. I said in my testimony as long as you borrow for productive purposes and you enhance the productive capacity of the United States and you do so at interest rates that are below your own growth rate, then you are not adding to that net burden.

But at the present time I don't think that those conditions are really fulfilled. We are borrowing a lot of these funds at the present time probably to finance our welfare expenditures and to finance our defense expenditures.

And the big question is whether our children should be paying for the defense expenditures and welfare expenditures that we are engaging in right now or whether it would be not more prudent to pay for those expenditures on a pay as you go basis.

Mr. **McKinnon**. I think Dr. Heller said it perfectly. As long as it is private—as American borrowing in the 19th Century was to build railways, ports, even some manufacturing facilities—then foreign investment is self-liquidating. As these projects come to fruition, the return flow of interest and dividends—in this case, back to London, in the 19th century—will evolve a counterpart trade surplus.

But the present capital inflow is due to the fiscal deficit, and is not self-liquidating. We will not automatically generate a trade surplus in the future—which is the counterpart of the present deficit. It requires a conscious act of public policy to make sure that that trade surplus is generated, and that takes the form of reducing the fiscal deficit.

Mr. **Jones**. I would only add that in the articles and speeches that are being presented on this subject, people are quick to say two things on the analogies to Brazil and Mexico today.

One is that it is not an exact analogy and two, it is highly instructional.

Senator **Mathias**. On that note of general agreement perhaps we should bring the morning session to a close. I want to thank all of the witnesses who have appeared. It has been a very stimulating and valuable exchange.

It will add a great deal to the perceptions of the committee as to the nature of the problem and, also, the seriousness of the problem. I think no one can hear this kind of testimony without having a renewed sense of dedication that we are really getting something done.

We will take a recess until 2 p.m., at which time we will return. And Professor Fishlow will return also and will be accompanied by Prof. Clark Reynolds of Stanford and Prof. Wayne Cornelius of the University of California at San Diego.

So, the committee will stand in recess until the hour of 2.

[Whereupon, at 12:05 p.m., the subcommittee was recessed, to reconvene at 2:10 p.m. this same day.]

AFTERNOON SESSION

[The subcommittee reconvened at 2:10 p.m., Senator Charles McC. Mathias, chairman of the subcommittee, presiding.]

Senator MATHIAS. Ladies and gentlemen, the subcommittee will come to order.

I regret that I was a few minutes delayed, but I had to make a call to Washington because all business is not suspended when you leave Washington, even when you come to such a delightful place as San Francisco.

I should further say that our hosts here at the council have announced their intention of reclaiming this room no later than 5 p.m. And we want to be well clear in advance of that time.

So I hope the witnesses will continue the practice which was begun this morning of summarizing statements. And of course the full statement will appear in the record as if it has been read.

The witnesses on the first panel this afternoon will be Professor Fishlow again, Prof. Wayne Cornelius as announced, and Prof. Clark Reynolds.

Is he——

Mr. JONES. He will be here shortly. He is our third witness on debtor nation's own policies.

Senator MATHIAS. All right, then we will start without Professor Reynolds and he will join us.

Professor Fishlow, are you going to lead off?

Mr. FISHLOW. Thank you very much.

In discussing the question of developing countries which is part of today's hearings, I want to really focus on four separate questions.

The first is, Why did they get into trouble? The second is, Why are the programs not working? The third is, What will they do with any new money they get? And fourth is the role of conditionality in encouraging better domestic policies.

With regard to the first, it is important I believe to differentiate among a variety of countries. The Latin American countries got into trouble as a whole compared to the eastern region because the Latin American countries went substantially into debt.

They went substantially into debt because it was very attractive. The debt was primarily used for investment rather than comsumption. The problem of capital flight, which is a serious problem in cases of Argentina, Mexico, and Venezuela, occurred after the problems had begun in 1980–81, rather than prior to that time.

In that sense, capital flight was in consequence of the international economic condition, rather than a cause of the countries getting into trouble.

The reason Latin American countries went into debt are multiple. They obviously bear a considerable part of the responsibilities themselves. And in the case of Mexico which obviously benefitted from the oil increase, as well as Venezuela, it is clear that poor domestic policy contributed significantly to their problems after international conditions turned out badly.

Once the debtor countries began undertaking the variety of stabilization programs, the evidence has been quite mixed as to their effectiveness.

On the whole, the country in which the programs have worked best has been Mexico. And that is in part because the diagnosis of the problem conforms most closely to the reality.

The Mexican case was one of excess aggregate demand and large government spending.

The problem with the fund is not so much the remedies that are proposed but the fact that it always diagnoses the problem as one of excess demand.

In many of the countries, most prominently Brazil and Argentina which had already experienced lower rates of growth, this was not the underlying cause of the difficulty compared to the adverse international circumstances.

One point that I think ought to be made is that the reason the programs are not working has nothing to do with the inability or unwillingness of the countries to make sacrifices. In the report of the Inter-American Development Bank, there is clear evidence of declines in real wages on the order of magnitude of 35 percent in the case of Mexico and something like 25 percent in the case of Brazil.

The other measure of the willingness to undertake sacrifices are the large trade surpluses that these countries in fact are producing.

As we heard this morning, the U.S. trade deficit is a measure of how much resources the United States requires in order to maintain our own levels of consumption and investment.

In the case of these Latin American countries at the present time, their exports exceed imports reflecting a use of domestic savings in order to cover their debt service payments.

The third issue, what the countries will do with the new money, obviously becomes relevant in the context of any program of relief. The issue is a clear one. If these countries already have such a large debt, what will they do with more of it?

The answer I believe is that the incremental resources can be effectively used in a variety of ways. In the first instance, investment rates have fallen to very low levels in virtually all of these countries.

In the second place, complementary opportunities exist in order to make more efficient the investments that were undertaken in the 1970's with the money that was borrowed at that time.

In the third instance, these countries need new money simply by virtue of the fact that something like 25 percent, and sometimes more, of their savings have been allocated to the payment of interest on the debt that they already have.

This reduction in available resources necessarily reflects itself in lower capital formation.

The final point, the role of conditionality, is again an obvious question. To what extent is it necessary to impose requirements on how the money gets spent in order to assure that it is spent well.

Here I think what the experience suggests is that where the policies are appropriate, they in fact succeed in getting internal support. Where the policies turn out to be inappropriate, what one sees is an unbroken record of letters of intent that have to be rewritten several times.

Under those circumstances, the fact of conditionality becomes a myth rather than a reality and we are far better trying to design stabilization programs that correspond to local consensus rather than imposing readymade solutions from the outside.

Thank you very much.

Senator **Mathias**. Thank you very much, Professor Fishlow.

Professor Cornelius.

I should perhaps say that Professor Cornelius comes from the Center for the United States-Mexican Studies at the University of California, San Diego. So he is ideally located to comment on the subject of this problem.

Go ahead, Professor Cornelius.

STATEMENT OF PROF. WAYNE A. CORNELIUS, DIRECTOR, CENTER FOR UNITED STATES-MEXICAN STUDIES, UNIVERSITY OF CALIFORNIA, SAN DIEGO

Mr. **Cornelius**. Thank you, Senator. I will deal primarily in my remarks with the case of Mexico, although I do think that there are many aspects of Mexico's recent experience that are generalizable to other Latin American debtor countries.

Three years ago, the government of Miguel de la Madrid embarked on a politically costly but financially necessary program combining short-term stabilization measures dictated by Mexico's recently signed agreement with the IMF, with the ambitious effort to promote long-term structural changes in the economy and in public finances, even at the price of slower growth in the short term.

De la Madrid and the technocrats in his economic cabinet seized upon the 1983 financial crisis as an opportunity to correct some of the basic structural problems whose presence was masked or even exacerbated by the oil boom of 1978–81—a highly inefficient industrial plant with little export capacity, overcentralization of economic activities, the proliferation of stateowned enterprises, and so forth.

The De la Madrid group, joined by most leaders of the private sector, felt strongly that if these kinds of fundamental, qualitative changes in national development policies were not made, the problems that led to the financial crises of 1976 and 1982 would inevitably reassert themselves with even more politically damaging consequences.

The need to bring Mexico's inflation rate down was also viewed in the context of what would be necessary to prevent a loss of political control. The inflation rate had quadrupled during the last year of the preceding administration. And with the new administration's tight wage policy, real incomes were dropping precipitously.

The new government concluded that maintaining social peace, at least in the context of a nonrepressive political order, would be impossible unless the inflation rate were drastically reduced.

Controlling inflation thus became the top priority of the new administration. But De la Madrid did pledge to protect as much as possible of the employment base by aiding financially distressed, debt-burdened private businesses. And in fact the flow of commercial credit through the nationalized banks to the private sector rose significantly in 1984 and so far in 1985.

The results of the program of short-term stabilization combined with long-term restructuring have been a very mixed bag. Annual inflation has been reduced from 100 percent to somewhere between 52 and 60 percent, but most of that reduction occurred during the first 2 years of the administration. And virtually no progress has been made on this front in recent months.

Government spending has been significantly reduced in real terms, and the deficit has been reduced by more than half, but Mexico has still fallen out of compliance with its IMF target for deficit reduction.

Economic growth has been restored at the rate of about 3.5 percent last year, and at least prior to the earthquake of this year a similar performance was expected for 1985.

But much of the new growth has been more capital-intensive and the rate of job creation is still not sufficient to keep pace with the growth of the economically active population, let alone help the more than 30 percent of the existing labor force who are either unemployed or underemployed.

Private sector confidence in the economy has been rebuilt gradually. There was a 9 percent increase in private investment last year. But private investment still has not reached the precrisis level and flight of domestic capital continues on a rather large scale.

After 2 years of marked improvement in Mexico's balance of payments, this year Mexico will probably run a trade deficit—and next year, as well.

This very mixed performance falls considerably short of the administration's own targets, as well as those imposed on Mexico 3 years ago by its external creditors.

The fragility and unevenness of the recovery has opened the government to harsh criticism from domestic adversaries of both the left and right, including many members of the government-ruling party apparatus itself.

De la Madrid acknowledges the widespread criticism of his policies but points out that the critics have yet to produce a credible alternative, assuming a continuation of highly adverse external economic trends, particularly the weakness of the oil market which has been far more adverse than the administration anticipated early in 1983 when its recovery plans were formulated.

The policy debate within Mexico has become increasingly acrimonious and divisive. Tensions between the technocrats who set policy and the traditional career politicians who run the official party and its affiliated mass organizations have deepened.

The general public mood seems to be one of increasing cynicism, skepticism about government initiatives. and hostility toward the political class, as well as a sense that their fate is being determined once again largely by external forces beyond their control—and indeed beyond the government's control.

In my prepared statement, I have from pages 11 to 14 a preliminary assessment of the fiscal and political impacts of the earthquake disaster of this past September. In the interests of time I will skip over that. I will be happy to answer questions about it in the discussion period.

I would summarize the outlook for 1985 to 1990 as follows. In light of the foreseeable resource constraints, as well as the De la Madrid government's own proclivities, a return to the overstimulative, highly expansionary policies of the late 1970's and early 1980's is most unlikely.

Earlier this year the government demonstrated its commitment to a policy of more moderate, but more sustainable, growth with lower inflation when it slammed on the brakes after two consecutive quarters of higher-than-expected growth at an annual rate of about 6 percent, which had generated too much pressure on price levels and on the balance of payments.

The real question for the last half of the De la Madrid administration, and I believe the remainder of the decade, is whether a socially and politically adequate rate of growth can be restored without high inflation.

How to grow again without inflation is a major unresolved policy dilemma that Mexico shares with Brazil and most other Latin American debtor countries.

What is painfully clear, after 3 years of relatively successful adherence to an IMF austerity program and the massive internal adjustments that it has entailed, is that the Mexican economy can never be restored to health without significant, and permanent, relief from the external debt burden.

Interest payments now take nearly 38 percent of the total Federal budget, a sum equal to all capital investment spending by the public sector.

Under this huge debt burden, directly productive government investment in infrastructure and other development projects has stagnated. Meanwhile, social pressures are accumulating rapidly.

Overall population growth has been reduced to about 2.2 percent per year. But in absolute terms, population growth remains formidable. In the last 3 years, more than 5 million persons have been added to Mexico's population.

And between 1985 and 1995, somewhere between 800,000 and 1 million persons will be added to the country's labor force each year.

Beyond these powerful demographic and economic imperatives, there is a powerful political need for lightening the foreign debt burden. The Mexican Government's ability to intensify austerity is nearing the limits of what is sustainable in the Mexican political system as it exists today.

Each new round of budget cuts—and there have been three such sets of cuts already this year—reduces the government's credibility and increases polarization within the ruling class, and provokes renewed capital flight.

Slowly but surely, the government's capacity to continue to implement its program of liberalizing, modernizing and mainstreaming the national economy is being undermined.

Up to now there has been no politically significant constituency in Mexico for a repudiation of the debt or a unilateral moratorium on interest payments. But such radical steps are bound to grow in favor unless Mexico's creditors and the U.S. Government demonstrate their responsiveness to the new situation created by slumping oil prices and the massive earthquake damage of last month.

These developments have significantly reduced Mexico's capacity to service its debt.

International interest rates are an equally—or perhaps even greater—potential source of fiscal disaster for Mexico. In the last 12 months there has been a slight drop in international interest rates which has enabled Mexico to compensate for the drop in its oil export revenues.

But if interest rates begin climbing again in response to U.S. Government deficits or other factors, Mexico will be severely impacted.

Given the very real risks of foreign exchange losses due to declining oil prices, a depressed tourist industry, and probably future increases in interest rates on the existing debt, Mexican officials are understandably reluctant to add much to the current debt-service burden in order to finance earthquake reconstruction.

I think this helps to explain why the finance ministry continues to insist that Mexico will only require $2.5 billion in new loans from commercial banks next year, an amount unchanged from pre-earthquake forecasts.

I think the implication is clear. The government will seek to reduce its outlays for interest payments on the debt already acquired through a new round of negotiations with the commercial banks.

In this regard, nothing that is currently being discussed as part of the new U.S. Government strategy for dealing with the Third World debt crisis is likely to do much to alleviate Mexico's dilemma.

Far more than the new bank loans and other inflows of funds that the United States is now encouraging in order to stimulate more growth, Mexico needs to reduce the outflow of resources via debt service.

It can no longer afford, socially and politically, to be a net exporter of capital to the United States and other industrialized nations. More rapid growth stimulated by new loans and foreign investments is necessary, but it is not an adequate prescription, certainly not for the medium to long term.

If a more socially desirable and politically necessary allocation of Mexico's own resources cannot be achieved, there is likely in my judgment to be a major policy shift in the next administration beginning in 1988, probably toward a more statist, nationalist, populist, closed-economy model, presided over by a more centralized and authoritarian regime.

Such a so-called correction may be inevitable after 6 years of austerity and declining living standards. But it probably would do no more than the current government's program of economic realism has done to improve the lot of the average Mexican, at least in a mixed economy where private-sector confidence is crucial to sustained growth.

And, almost certainly, the consequences of such a policy shift would be more difficult for the United States to live with. Thank you.

[Mr. Cornelius' prepared statement follows:]

PREPARED STATEMENT OF WAYNE A. CORNELIUS

THE REDIRECTION OF MEXICO'S POLITICAL ECONOMY, 1982-1985

Three years ago, the government of Miguel de la Madrid embarked on a politically costly but financially necessary program of what it termed "economic realism." It combined short-term stabilization measures aimed at bringing down a 100% inflation rate and restoring confidence in the economy with an ambitious effort to promote long-term structural changes in the economy and in public finances, even at the price of slower growth in the short term.

Short-term stabilization was to be accomplished mainly through government belt-tightening and wage restraint enforced by the government-controlled labor unions. The prices of many goods and services produced by the public sector rose dramatically as the government tried to increase revenues, and the reduction of government subsidies to private producers caused similar increases in the price of food and other basic consumer goods.

Given the depletion of government revenues by December, 1982, and the conditions attached to Mexico's bail-out loan from the IMF, there was no no real alternative to a drastic austerity program. But De la Madrid seized upon the crisis as an opportunity to correct some of the country's basic structural problems: a highly inefficient and globally uncompetitive industrial plant, overcentralization of both public and private sector activities, proliferation of unprofitable state-owned enterprises, and an elaborate set of government subsidies, protectionist tariffs, and unrealistic exchange rate policies that were distorting the way in which resources in the economy were allocated. The De la Madrid group, joined by most leaders of the private sector, felt strongly that if a fundamental, qualitative change in national development strategy were not made, the problems that led to the financial crises of 1976 and 1982 would inevitably reassert themselves, especially in the context of a world economy that was likely to hinder rather than facilitate Mexico's recovery.*

Such a failure to provide effective, durable solutions to the country's problems would, in the De la Madrid administration's view, set the stage for a catastrophic breakdown of the political system. The legitimacy of that system had been severely eroded by a succession of government performance failures dating back to 1968. It was politically imperative that the De la Madrid administration put into place a set of policies that would enable Mexico to grow less spasmodically in the future -- to break out of the "boom-and-bust" cycle that has operated since the 1970s; policies that would make the Mexican economy more competitive internationally, and make it less vulnerable to external economic shocks (especially fluctuations in oil prices and international interest rates). The need to bring down Mexico's inflation rate was also viewed in the context of what would be necessary to prevent a loss of political control. The inflation rate had nearly quadrupled during the last year of the preceding administration; and with the new administration's tight wage policy, real incomes were dropping precipitously -- by 23 percent in 1983 alone, with an additional 10 percent in the previous year. The De la Madrid group recognized that social peace could not be maintained -- at least within a non-repressive political order -- unless inflation were drastically reduced.

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*For a more detailed analysis of the rationale underlying De la Madrid's strategy for economic recovery, see: Wayne A. Cornelius, "The Political Economy of Mexico Under De la Madrid: Austerity, Routinized Crisis, and Nascent Recovery," Mexican Studies (University of California Press), Vol. 1, No. 1 (Winter, 1985), pp. 83-124.

Controlling inflation thus became the new administration's top priority. Given that government spending was the principal contributor to the hyperinflation of the preceding sexenio, the fight against inflation precluded new, large-scale government programs and infrastructure projects. Under De la Madrid there would be no vast new rural development schemes, no massive job-creation programs, no spectacular public works in Mexico City. De la Madrid did pledge to protect as much as possible of the employment base by aiding financially distressed, debt-burdened private businesses (commercial credit to the private sector from the nationalized banks rose 17 percent during 1984 and continued strongly through the first two quarters of 1985). And the administration's substantial expenditures for health care, education, and social security have been aimed at maintaining as much as possible of the cushion of benefits that the government traditionally has offered to the more privileged segments of the working class (primarily unionized workers) and the middle class. Accordingly, the lion's share of cuts in government spending under De la Madrid have been in the capital investment budget rather than current expenditures.

The results of this program of short-term stabilization *cum* long-term restructuring have been a mixed bag. Annual inflation has been reduced from 100% to somewhere between 52-60%, but most of the reduction occurred during the first two years of the De la Madrid administration, and virtually no progress has been made on this front in recent months. Mexico's IMF target for inflation in 1985 was 35 percent. Inflation seems to be stuck in the 50-60% range, and there is talk of price and wage freezes in order to contain the new inflationary pressures unleashed by the recent earthquake damage.

Government spending has been significantly reduced, in real terms, and the deficit has been reduced by more than half since 1982, to about 7.2% of GDP; but Mexico has not achieved its IMF target for deficit reduction (5.9% of GDP). De La Madrid has made real progress toward putting the public sector of the economy on sounder financial footing (including self-financing of expansion), bringing PEMEX (the state oil agency) under central control, and pruning back the public sector to eliminate non-essential and financially non-viable enterprises. He has ordered the merger, liquidation, or sale of 482 "non-strategic, low-priority" state enterprises, out of a total of 1,155 entities that formed part of the public sector at the end of 1982.

After negligible growth in 1982 and a disastrous contraction in 1983, the economy grew at 3.5% last year, and at least prior to the earthquakes of September, a similar performance was expected this year. Much of the new growth has been more capital-intensive, however, and the rate of job creation is still not sufficient to keep pace with the growth of the economically-active population, let alone help the more than 30% of the existing labor force who are either openly unemployed or underemployed.

Private-sector confidence in the economy has been rebuilt gradually, reflected in a 9% increase in private investment during 1984; but private investment still has not recovered to the pre-crisis level. Flight of domestic capital continues on a large scale (an estimated $2.8 billion in 1984; probably at least as much this year), and our Center's interviews with a sample of wealthy Mexicans who have participated in this capital movement suggest that no appreciable portion of this flight capital will be repatriated in the foreseeable future, regardless of what the De la Madrid administration may do. And after two years of marked improvement in Mexico's balance-of-payments, reflecting both the severe recession-induced contraction of imports and the government's export-promotion policies, the trade surplus this year will shrink by $1-2 billion.

This very mixed performance falls considerably short the De la Madrid administration's own targets, as well as those imposed on Mexico three years ago by its external creditors. The fragility and unevenness of the recovery has opened De la Madrid to harsh criticism from domestic adversaries of both the left and right, including many members of the government-ruling party apparatus itself. At the midpoint of his presidency, De la Madrid increasingly is viewed as a weak president who is either unwilling (for ideological reasons) or unable (for lack of a broad political base) to take the extreme steps that they consider necessary to deal effectively with Mexico's deep-seated economic and social problems, and whose administration often sends contradictory signals that further undermine public confidence.

Left-nationalist critics condemn the administration for sacrificing socially necessary economic growth in an obsessive pursuit of lower inflation rates; for opening Mexico's

economy too much to foreign investment and to foreign-made goods; for failing to bargain harder with the foreign banks and the IMF; for divesting too many state-owned enterprises to the private sector; and for trying to reduce government deficits mainly through spending cuts rather than increasing revenue through a crackdown on tax evasion by the wealthy, among other steps. Some are also critical of De la Madrid's governmental decentralization program, which has doubled the amount of resources in the hands of the state governors in just three years, leaving the federal government, in their view, strapped for funds which it might invest more productively.

De la Madrid's critics on the right -- especially big businessmen -- fault him not for the basic direction of his policies but rather for not going far enough: that is, by dismantling the state sector more rapidly, reducing the deficit through even more drastic cuts in spending, squeezing down inflation faster, and opening the economy even more to international market forces, e.g., by joining the GATT. Conservatives see the De la Madrid administration as too willing to compromise its objectives for political reasons. Thus they criticize the relatively mild relaxation of government austerity in 1984 as premature and politically motivated (others viewed that year's increased spending on social programs as a pragmatic recognition that, especially among urban-dwelling Mexicans, there are limits to public tolerance for adversity, as well as to the capacity of traditional political arrangements to contain discontent). Similarly, they criticize the government's apparent unwillingness or inability to pursue more aggressively its highly-touted campaign against corruption in the bureaucracy and the powerful unions of government workers -- a campaign whose repercussions could possibly destabilize the political system if prosecutions reached too high and affected too many well-connected people.

De la Madrid acknowledges the widespread criticism of his policies, but points out that the critics have yet to produce a credible alternative, assuming a continuation of adverse external economic trends (slumping oil prices, high real interest rates, lack of dynamism in the U.S. economy, contraction of voluntary lending by commercial banks, rising protectionism in industrialized countries, etc.). He argues that too much attention has been focused on economic recovery targets (and the failure to achieve them), and not enough on the progress that has been made since the new administration took over (December, 1982). International economic conditions -- particularly the weakness of the oil market -- have been far more adverse than the administration anticipated early in 1983 when its recovery plans were formulated. In the administration's view, the results that have been achieved thus far, despite these circumstances, justify a decision to stay the course.

De la Madrid and his cabinet have also been trying to lower public expectations about what can be accomplished in the remainder of their term. As De la Madrid put it in his third state-of-the-nation address, delivered on September 1, 1985, "The task that falls to this administration is to lay the groundwork and set the course of change, and to advance as far as possible in that direction, but without assuming that the history of Mexico begins or ends with us." Finally, top government officials dismiss the charges of weakness and temporizing in the government's handling of the crisis. "The country could not have gotten through the last three years without a firm hand," they argue.

Clearly, De la Madrid has not proven to be a miracle-worker. His policies have angered many of the government's traditional constituencies, and he has failed to develop a broad political consensus around his approach to the economic crisis. The policy debate within Mexico's ruling elite has become increasingly acrimonious and divisive. Tensions between the technocrats who set policy and the traditional career politicians who run the official party and its affiliated mass organizations have deepened. And the De la Madrid administration has failed to restore the confidence of most members of the general public in the government's ability to manage the economy. Opinion polls taken just after De la Madrid's most recent state-of-the-nation address showed that only 35% of those interviewed expressed confidence in the president's policies. The general public mood seems to be one of cynicism, skepticism about government initiatives, and hostility toward the political class, as well as a sense that their fate is being determined largely by external forces beyond their control (and, indeed, beyond the government's control).

Earthquake Impacts

In their haste to find a silver lining somewhere in Mexico's recent earthquake disaster, many foreign observers have been speaking of reconstruction as an opportunity for Mexico to restore national unity and solve some of the country's most pressing problems. In fact, the financial and political aftershocks pose a severe hazard to Mexico's recovery.

It is true that the reconstruction effort will absorb some of the country's unemployed and underemployed workers into temporary jobs. The disaster may cause some -- but by no means all -- of Mexico's 634 external creditors to be more lenient. Politically, the disaster will have a unifying effect on public opinion and temporarily dampen the increasingly bitter debate over De la Madrid's policies, *if* the government can head off a scandal over earthquake damage and casualties resulting from lax building-code enforcement practices. And the administration may be able to proceed somewhat farther with its plan to decentralize certain government activities away from Mexico City, *if* it can overcome the bureaucrats' usual resistance to relocation outside of the capital, among other obstacles.

But all of these beneficial effects are certain to be short-lived; and they pale beside the immense liabilities resulting from the disaster:

- A considerable increase in inflationary pressures caused by the inevitable spending for reconstruction.
- The diversion of scarce public resources away from long-term investments that might increase national production capacity and create permanent jobs.
- A sharp reduction in income from tourism (tourist traffic arriving by land already was down 20% this year, due primarily to alarmist U.S. Government statements about crime in Mexico).
- A higher import bill, worsening Mexico's balance-of-payments deficit.
- Damage to the financial system resulting from the loss of records in more than 120 buildings that housed government agencies, including the Finance and Commerce ministries and several state-owned banks.

The damage to physical structures, communications and other infrastructure in Mexico City has been estimated at $4-5 billion. Finance Minister Jesús Silva Herzog recently informed Mexico's external creditors that the earthquake-related loss of dollar reserves in Mexico's central bank would be $700 million in 1985 alone, including $300 million due to reduced tourism and $300 million for imports of emergency telephone and hospital equipment.

The disaster has also added considerably to the misery of Mexico City's 18 million residents (nearly one-quarter of the country's total population), who were already among the most politically alienated and psychologically stressed people in the nation. Now, up to 300,000 of them are temporarily homeless, and several millions have have had their water supply disrupted. In the mid-term elections of this past July, the government party failed to win even a bare majority of the capitalinos' votes. Further erosion of popular support could result from any mishandling of the reconstruction effort (especially misappropriation of international relief contributions), and from the additional reductions in government spending on various programs and cuts in government payrolls that will be necessary to free resources for reconstruction.

A worsening of inflation resulting from reconstruction spending would compound the government's political difficulties, not just in Mexico City but throughout the country. De la Madrid from the outset of his term has regarded inflation as the gravest threat to Mexico's political stability, and even before the earthquakes administration officials were concerned that if the present inflation rate is not brought down, any external shock to the economy might again send inflation through the roof. The earthquake damage could easily provide that shock, especially if the government is forced to finance much of the reconstruction by going to the printing press.

It must be kept in mind that an inflation rate of 50-60 percent in Mexico is as damaging politically as an inflation rate of 200 percent in countries like Brazil and Argentina.

Mexico, virtually alone among the major Latin American nations in this century, has not been a "high inflation" country. Its people are not accustomed to life in an economy where purchasing power diminishes noticeably on a daily or weekly basis. Most Mexicans lost at least a third of their purchasing power between 1981 and 1985, and even before the earthquakes none of this lost ground was likely to be made up in 1985. In real terms, minimum wages in 1984 were at the same level as in 1964; and disposable income per capita in 1984 was comparable to that of 1974. The overt political consequences of this retrogression to date have been manageable, largely because of labor discipline enforced by the 85-year-old leader of the government-affiliated labor confederation, Fidel Velázquez, and because of the failure of opposition parties to present a credible alternative policy and mobilize popular support for it. But it is doubtful that this kind of political control could be maintained in the face of a new episode of hyperinflation.

Outlook for 1985-88

In light of the foreseeable resource constraints and the De la Madrid government's own proclivities, a return to the overstimulative, highly expansionary policies of the late 1970s and early 80s is most unlikely. Earlier this year the government demonstrated its commitment to a policy of more moderate (but more sustainable) growth with lower inflation, when it slammed on the brakes after two consecutive quarters of higher-than-expected growth (an annualized growth rate of more than 6%), which had generated too much pressure on price levels and on the balance of payments. The real question, for the last half of the De la Madrid sexenio and the remainder of the decade, is whether a socially and politically adequate rate of growth can be restored without high inflation. How to grow again without inflation is a major unresolved policy dilemma that Mexico shares with Brazil and most other Latin American debtor nations.

What is painfully clear, after three years of relatively successful adherence to an IMF austerity program and the massive internal adjustments that it has entailed, is that the Mexican economy can never be restored to health without significant -- and permanent -- relief from the external debt burden. Interest payments, now totalling about $12 billion a year, take 37.5% of the total federal budget, including payments on both the internal and external public debt. Debt service on the externally-held portion represents more than 20% of the total budget, and is equivalent to all capital investment by the public sector. Under this huge debt burden, directly productive government investment in infrastructure and other development projects has stagnated. In sharp contrast to all other recent administrations at a comparable stage, the De la Madrid government in 1984 launched no major public investment projects whose benefits would be realized in the medium-to-long term, and none are in sight for 1985. As the United Nations' Economical Commission for Latin America (CEPAL) observed in its most recent report on the Mexican economy, "the sacrifice of public investment programs has been one of the greatest costs incurred [by Mexico] in terms of its possibilities for longer-run economic development."* Mexico, in short, is no longer investing sufficiently in its future.

Meanwhile, social pressures are accumulating rapidly. Overall population growth has been reduced, by a combination of government promotion of family planning, rising education levels, and adverse economic conditions, to about 2.2% per year. In absolute terms, however, population growth remains formidable: between 1982 and 1985, more than 5 million persons were added to Mexico's population (now more than 78 million). And between 800,000 and 1,000,000 persons will enter the country's labor force each year during the 1985-1995 period. Pressures for emigration to the United States will build inexorably if Mexico's employment base cannot be expanded at a rate considerably above the present 2.7% per annum.

Beyond these powerful demographic and economic imperatives, there is a very explicit *political* need for lightening the foreign debt burden. The Mexican

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*Naciones Unidas, Comisiòn Econòmica para Amèrica Latina y el Caribe, *Notas para el estudio econòmico de Amèrica Latina y el Caribe, 1984*: *Mèxico*, Doc. LC/MEX/L.5/Rev.1, June 7, 1985, p. 68.

government's ability to intensify austerity is nearing the limits of what is sustainable in the Mexican political system in its present form. Each new round of budget cuts -- there have been three sets of cuts already this year -- reduces the government's credibility and increases speculation, capital flight, and political polarization. Slowly but surely, the government's capacity to continue to implement its program of liberalizing, modernizing, and mainstreaming the national economy is being undermined.

Up to now there has been no politically significant constituency in Mexico for a repudiation of the debt or a unilateral moratorium on interest payments. But such radical steps are bound to grow in favor unless Mexico's creditors and the U.S. Government demonstrate their responsiveness to the new situation created by slumping oil prices and the massive earthquake damage. Mexico's capacity to service its debt has been diminished significantly by these developments. Mexico will lose an estimated $2 billion in oil revenues this year because of lower prices and lower sales volumes (PEMEX has been forced to cut the price of its exported crude three times thus far in 1985 to maintain its customers). This is the fourth consecutive year of declining oil prices, and most experts anticipate continued downward pressure in 1986 as various OPEC members demand higher production quotas. At Mexico's current level of oil exportation, each $1 drop in the price will cost the treasury about $560 million.

International interest rates potentially are an even greater source of fiscal disaster for Mexico. Slightly lower interest rates during thepast 12 months have enabled the government to compensate for the drop in oil export revenues; but if interest rates begin climbing again, in response to U.S. government deficits or other factors, Mexico will be severely impacted. In this respect, Mexico is more vulnerable than some other major Latin American debtor countries (e.g., Brazil), since a higher proportion of its total foreign debt is subject to variable interest rates that are sensitive to changes in the U.S. prime.

Given the very real risks of foreign exchange losses due to declining oil prices, a depressed tourist industry, and probable future increases in interest rates on the existing debt, as well as rising domestic political resistance to pressures from external creditors, Mexican officials are understandably reluctant to add much to the current debt-service burden to finance earthquake reconstruction. This helps to explain why the Finance Ministry continues to insist that Mexico will be seeking no more than $2.5 billion in new loans from commercial banks in 1986 -- an amount unchanged from pre-earthquake forecasts. The implication is clear: The government will seek to reduce its outlays for interest payments on the debt already acquired, through a new round of negotiations with the commercial banks.

These are dangerous times for Mexico's leaders. Before the earthquakes they seemed resigned to slogging through their last three years in office, making steady but undramatic progress in reordering the economy and paving the way for greater achievements under their successors. And most of the Mexican public seemed to be expecting no more. But as great earthquakes in other Latin American countries have demonstrated (the case of Managua in 1972 is the clearest example), such events can swiftly alter the political equation. The Mexican people will now expect more from their leaders than three years of muddling through, with calls for greater sacrifices. As Finance Minister Silva Herzog told a group of money-center bankers in New York a few weeks ago, "We can no longer keep seeking sacrifices from the people without offering them anything in return."* De la Madrid's ability to deliver more will depend on a significant loosening of external financial constraints, as well as new capital flows.

Again, the key factor is interest rates on the existing debt. Principal payments on most of Mexico's debt have been rescheduled. A major reduction in interest rates will be necessary, and perhaps additional steps like setting a ceiling on annual interest payments as a percentage of export earnings.

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*Quoted in The New York Times, September 2, 1985.

In this regard, nothing that is currently being discussed as part of the new U.S. Government strategy for dealing with the Third World debt crisis will do much to alleviate Mexico's dilemma, especially in the medium-to-long term. Far more than the new bank loans and other inflows of funds that the U.S. is now encouraging in order to stimulate more growth, Mexico needs to reduce the outflow of resources via debt service. Only in this way can Mexico achieve a more socially desirable and politically stabilizing allocation of its own resources. It can no longer afford to be a large-scale net exporter of capital to the U.S. and other industrialized nations. New loans and foreign investment are being proposed by the U.S. as a substitute for interest rate reduction; for Mexico, at least, that is simply not an adequate prescription.

Senator **Mathias**. Thank you very much, Professor Cornelius.

Mr. Reynolds has not yet arrived, so let's go forward with our discussion. I appreciated Professor Cornelius in the economy of time skipping over the effects of the earthquake. But I think that is a subject that is so topical that we can't avoid it.

Let me go back to your written statement. And for those in the room who have not had the opportunity to read your written statement, let me quote:

> If the present inflation rate is not brought down, any external shock to the Mexican economy might again send inflation through the roof. The earthquake damage could easily provide that shock, especially if the government is forced to finance much of the reconstruction by going to the printing press.

That seems to me to summarize your conclusion on that subject. But just how acute is this problem?

Mr. **Cornelius**. Well, clearly the resources for earthquake reconstruction are assets which do not now exist. They were not programmed, there was no contingency fund——

Senator **Mathias**. Do we have any realistic idea of the magnitude of the problem in dollar terms?

Mr. **Cornelius**. At this point it is impossible to make more than a very general guesstimate. But the estimates being produced by government agencies in Mexico range in the $4 to $5 billion area simply for physical reconstruction and repairing of critical infrastructures such as telephone communications, hospitals, and schools.

The Finance Minister——

Senator **Mathias**. That is not total restoration?

Mr. **Cornelius**. Oh, no, that is——

Senator **Mathias**. That is just what?

Mr. **Cornelius** [continuing]. Just physical damage and restoring the major medical centers that were destroyed and telecommunications.

The Finance Ministry in its memorandum to the U.S. banks that was distributed I guess about 10 days about estimates that central bank reserves can be reduced by about $700 million in 1985 alone because of lost revenues from tourists and other costs directly resulting from the earthquake.

Putting a price tag on other potential liabilities, such as an increased import bill, damage to the financial system resulting from destruction of records, and so forth, is almost impossible at this point.

But as I indicated in the statement, I do think the single most pressing difficulty resulting from this tragedy is the new source of inflationary pressure which the inevitable spending for reconstruction will generate.

Senator **Mathias**. Let me ask each of you this question. The focus of a lot of the discussion on international debt inevitably centers on the big debtors, Mexico, Brazil, Argentina, and there are concerned international efforts to deal with those problems.

The governments get involved, both the creditor governments and the debtor governments. The banks meet together. It's a little like the old saw, it you are going to be in debt—don't be in debt for $5,000—$5 million is a much safer amount to be in debt.

But what is the case with the smaller debtor countries? Do you have desperate problems like Peru where the unemployment is running at 50 percent, where the external debt is substantial, where the economy is in desperate trouble in all respects.

Bolivia is another case that comes to mind. Even Coasta Rica which is a relatively fortunate country has debt problems. They do not get the same concentrated attention that Brazil, Argentina, and Mexico get.

Has the private sector been willing to go the extra mile in assisting the smaller countries?

Mr. FISHLOW. I think on the whole you are quite right, Senator. One of the problems with the smaller countries, there is no system threatening as being perhaps the worst victims in this particular crisis.

The one country that you didn't mention has one of the highest ratios of interest payments to income is actually Chile, and has been severely affected in terms of its own growth prospects.

I think the answer has been that many of these smaller countries have on the one hand not maintained their payments. Bolivia and Peru are two prime examples of countries that have simply not sustained their interest payments.

Costa Rica has engaged in a austere program of stabilization which has provided some success. Chile has managed just barely to obtain additional funds from commercial banks in conjunction with the World Bank in a cofinancing scheme.

I think that the policy has been to worry about the financial system and hope somehow or other that these cases will later be accommodated.

In a curious way, it is one of the weaknesses of the case-by-case approach. But we haven't really looked at these countries and said that Bolivia is a case where the debt clearly cannot be paid, and something will have to be done to get it off the books so that a fresh start can be made.

Or that in the case of Chile, it will be necessary to write it down sufficiently in order to make the interest payments commensurate with——

Senator MATHIAS. Those are chilly words, writing it down.

Mr. JONES. Yes.

Senator MATHIAS. Before we turn to Professor Reynolds, let me pursue this just one other step. Are the much smaller countries plagued by more flight of capital than the larger countries?

Mr. FISHLOW. On the whole, the capital flight problem has not been an important part of the issue. Bolivia of course is a very special case in which the question of both incoming proceeds and outgoing proceeds is a matter of some speculation.

But certainly not part of the situation that has afflicted the smaller countries, especially, as a cause of their difficulties.

Senator MATHIAS. I recall that when the so-called nonpartisan Commission on Central America, the Kissinger Commission, met with President Munez of Costa Rica, he was lamenting the lack of capital for expansion of the economy.

And he said, "Well, Costa Rica by definition is a rich country. Where is your money? And his answer was, "In Miami."

Mr. **Fishlow**. That of course has to do with a more special noneconomic situation in the case of Costa Rica that doesn't apply in the case of some of the others. So I hope that we won't generalize from that.

Senator **Mathias**. Yes.

Mr. **Jones**. Senator, when you and I attended the Atlantic Conference in Argentina last November which you chaired, Rimmer De Vries of Morgan Guaranty announced to the group that many of the center-city banks had already allocated loss loans reserves against the Chiles and the Perus and the Bolivias, and were therefore shifting their attitude to a point where they were saying they could wash their hands of the situation there because each one of these countries was small anyway.

Some of the senior officials of the World Bank have commented on that and said, "That may be true of one country at a time, but if two or three of them go it is the equivalent of a large country and does have a domino effect as well."

And the notion that the private banking system is now able to wash its hands of it and not worry about these smaller countries simply make the situation more serious rather than less in that it overlooks the risk of a domino effect.

Senator **Mathias**. So it is an area of special concern?

Mr. **Jones**. I think so.

Senator **Mathias**. We have been joined by Professor Reynolds, who we are happy to welcome here. He is a professor at Stanford University, and we will ask him now if he will give us his statement.

Professor Reynolds, before you came in I explained that we are under some pressure of time, so if you could summarize your statement the full statement will be included as part of the record.

Mr. **Reynolds**. Thank you very much, Senator. I would like to introduce into the record my formal statement, as well as a piece of research we did for your committee on "The Impact of California of the Latin American Debt Crisis."

Senator **Mathias**. That would be very helpful. And both will be included as a part of the record.

STATEMENT OF CLARK W. REYNOLDS, PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY

Mr. **Reynolds**. Very good. I have several points to make in summary based on the work we have been doing, not only with our Mexico-United States project, but also on a larger exploration of the United States-Latin American relationship.

The first major point is that we are seeing a new look at the debt question, even over the last few weeks, that tends to confirm what many of us have been concerned about for the last 2 years and which at one point was called a pessimistic or debt-pessimistic approach, but which is now becoming what one might say is a realistic approach calling for a very fundamental change in the way we look at the debt relationship.

This new approach really turns around the order of thinking. Up until recently the order of thinking in the north was not very comparable to the way of thinking in the developing or debtor countries.

The look in the north was primarily what are the conditions necessary for these countries to service their debt. To what extent does it relate to alternative growth scenarios and to what extent could the north be an engine of growth that would pull the debtor countries forward in a way that would permit them to service their debt.

On the other side of the fence, so to speak, the attitude was quite different, although for the most part there were general friendly relations. The view from the south was much more holistic.

It saw the debt as a problem confronting growth, rather than their growth as a way of servicing the debt. And not only economic growth, but social democratization. As a matter of fact, most of the countries that incurred the largest debt were either under authoritarian regimes or single-party regimes at the time that they acquired their debt.

And yet now many of these countries, happily a good share of them, are beginning to move toward democratization. This puts them under a far greater pressure from the social and political point of view to look at the debt in a holistic way as part of their overall evolutionary process, and also puts them under tremendous pressure, social and political pressure, to explore the causes of the debt and the consequences for the change in the order and nature of their regimes.

Now, I think this is a window of opportunity. But mainly if we are better able to deal with them in the terms which they consider essential in their own self-image of the debt problem.

I am not suggesting whatsoever here that the one side surrender to the other side. I am just saying that the idea of what is the growth rate that is needed to get them out of this box isn't the perspective anymore that is relevant. Happily at our highest levels of leadership we are beginning to see this message get across.

Unfortunately, that is not percolating down yet. And I think it is incredibly important that the Congress play a critical role in this process because, as a matter of fact, you really reflect the rank and file of public opinion and influence it to a large extent.

The second point I want to make is what I call the debt-growth tradeoff. Turn the thing around. From the Latin American point of view, and I could speak particularly for countries which are relatively favored countries in this business like Mexico, the debt stands in the way of growth. It is not the other way around. It is not that growth will permit the debt to be serviced.

So debt stands in the way of growth. Not only as an objective amount of service payments or actual or postponed principal payments, but as a dark cloud on the horizon that inhibits the investment of private funds, inhibits long-term planning, inhibits any stable economic or political future arising which is so essential to these countries and I think we can show clearly to our own interest.

Let's look at the Mexican case. The reason I am looking at the Mexican case—there are two reasons, basically. First, we are very well-informed about that case. And, second, it is regarded as a lucky country in the sense that it has got oil, it was reasonably industrialized before the crisis began, it had 8 percent growth for 4 consecutive years before the crisis, so it had grown by one-third in 4 years. And, finally, it is next door to the United States. So most other countries regard it as a special, lucky case.

We have done some homework here——

Senator MATHIAS. That hasn't been the universal perception of Mexican politicians, however. Who was it said, "Poor Mexico, so near to the United States and so far from God"?

Mr. REYNOLDS. Yes, it is in my book about Mexico.

Senator MATHIAS. We know how to flatter our witnesses.

Mr. REYNOLDS. The feeling—I am not talking about the advantage of being next to the United States from the social and political point of view. I think you work out your own destiny. But the advantage from the point of view of working out your financial problems. There is a little advantage there, I think you would agree with me on that.

Because the United States simply cannot afford to let Mexico go upside down. And I am not saying we should, but we probably feel, many of us, that we could afford to let other countries go at least halfway upside down before we look hard at how we can be economically supportive.

Mexico is in a real debt squeeze right now. This is a new dimension of a problem. And we did some homework on this and we have some numbers that are inserted in the record which indicates that this is the first year after I think quite an impressive adjustment process and a gradual recovery. This is the first year Mexico is really going to be up against it for paying the interest on its debt.

Now, there is good news and bad news. The bad news is what I just said. The good news is that there seems to be a very open and gentlemanly disposition on the part of Mexico and some of the top creditor institutions to do a deal which will permit them to garner more money in order to meet the debt service payments. I wouldn't be surprised if we see some of that take place.

But the fact of the matter is, it should be understood that the debt service payments are either going to come partly out of reserve or partly out of new borrowings. And one of the main reasons is that recent recovery of Mexico led to a rate of growth in the first half of this year which even the Mexican Government admits was overdoing it but which shows how volatile the country is in terms of its debt service capacity if it just recovers.

Because as soon as it starts to recover, the exports actually went down, including nonoil exports, and the imports went way up because they need imports in order even to export and certainly to get ahead.

Now that was before the earthquake. The earthquake might add to our tables another billion or so, according to Silvo Herzog, the Finance Minister's recent report.

Mexico, in other words, which is in one of the better positions among the Third World countries, is in a definite box. This is a quandry for the Government because the Government has been what you might call a very good performer in terms of its dealings with the international financial community, the Fund and so forth.

Yet I think it is fair to say that times are changing and that the Mexicans, while they want to go ahead and be cooperative, are only going to do so if they can effectively see some way of working out a very fundamental new approach to both their service payments, interest payments and to the real values of the principal.

Now, this—it may be fortunate, it may not be fortunate, but this particular country is in a de facto intermediary role between the worst performers or the least disposed to perform and the United States.

It is something like the role that Britain was in after World War II. And as a matter of fact, the British debt after World War II to the United States in constant dollars was almost exactly the same or a little less than the Mexican debt today in constant dollars.

It was very clear after the war—in the Anglo-American agreement and other agreements—it was clear that there was no way that Britain could recover and grow and at the same time meet its foreign obligations.

Because that country was an ally, and because we had some very far-sighted people in both Governments and society as a whole saw solidarity in terms of their respective interests, Britain was given a tremendous lease on life.

Instead of asking them to pump real resources out of Britain after the war to pay off their borrowing, resources were pumped into Britain. Instead of requiring them to meet the balance of payments and obligations immediately, and that was the center of the sterling area, they were allowed to have 20 years or so to work out their obligations.

Now, the future prospects of our economic and commercial relations with Britain at that point were far less optimistic than our future prospects with Mexico. Moreover, it was not on the American border, nor were we receiving a massive amount of labor coming out of Britain as a safety valve if Britain couldn't perform effectively.

On the other hand, it was an English-speaking country and it was an ally during the war—just as Mexico is, for that matter, and Brazil and other Latin American countries.

There is a lesson there. I think the lesson is, that if there is no way that the real obligations of a country can be met without strangling it, boxing it in and turning it upside down, you have to work something out.

And I think this is just a fact of life. We have got to this point, many people predicted it several years ago. Some said it wasn't going to happen. But it has happened. And so we have to develop a workout.

The workout can be in the statesmanlike character that the workout for Britain and the other countries including our enemies—war-time enemies—was at that point in history.

This is where I think we are today. And I would be glad to listen to or respond to any questions.

[Mr. Reynolds's prepared statement with attachment follows:]

PREPARED STATEMENT OF CLARK W. REYNOLDS

INDEBTED DEVELOPING NATIONS POLICIES AND IMPACT ON THE U.S.

Clark W. Reynolds
Professor of Economics
Food Research Institute
and Director
U.S.-Mexico Project
Stanford University

Prepared with the assistance of Robert K. McCleery

A New Look at the Debt Question: These remarks are to provide a perspective on the debt problem from the developing countries' viewpoint, with particular attention to Latin America, as a guideline to actions which the U.S. might take in its own interest at this critical moment in global relations. Most of the developing countries have imposed severe adjustment policies on their economies and societies in the past few years, in order to meet at least a portion of previously contracted external obligations. But today time is running out on social tolerance for belt-tightening, putting great pressures on the political leadership of these countries, caught as they are between a rock and a hard place.

Much of the debt was contracted by earlier authoritarian or one-party regimes. Ironically the debt crisis itself helped to draw attention to the shortcomings of governments which were willing to mortgage the future of their societies in order to buy power for the present. Most of the debtor nations are now experiencing growing pressures for increased political and economic participation. The debt is unanimously perceived to be a major obstacle to future growth and democratization, especially in the Americas from the Southern Cone to the Mexican border. Yet the conventional view of the problem from outside of the region, including Washington, focuses on the conditions for debt payment rather than the underlying process of economic and social evolution essential for stability in the third world.

Only in the past few weeks has it begun to be apparent to lending countries that the debt itself may be the prime obstacle to effective recovery and growth. What was termed "super pessimism" in earlier discussions of the debt, referring to the position that recovery in the developed world alone would not be sufficient to pull developing countries out of the crisis, is becoming more widely accepted, even at the highest policy level in the United States. As a result, the simple economics of debt service capacity is giving way to a more comprehensive perspective based on the political economy of interdependence. For this reason, it is now becoming possible to listen to constructive suggestions from those moderate sources both north and south, who are calling for a new look at the debt.

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__The Debt-Growth Tradeoff__: Most Latin American countries are presently required to run a large export surplus in order to service at least part of their foreign borrowing. This is a condition on which postponement of most principle and modest additional lending depend. Yet the result is that as much as six to eight percent of GNP each year flows abroad as a "net savings outflow" that is not available for domestic capital formation. This situation could be compared with a "reverse Marshall Plan" which instead of providing external resources for recovery and growth draws them out of the developing world to support higher consumption levels of creditor nations, including the U.S., that are content to consume international capital in order to keep their own economies and societies from adjusting. Unfortunately the net result is to lower the global rate of savings and investment, since much of the future development potential is in the South.

What is needed is not so much a "Marshall Plan" of new capital injections into the third world as major relief from net resource transfers out of the region to service previous borrowing. The current process of periodic postponement of principal payments does not eliminate the dark clouds of eventual crisis which stand in the way of substantial long term commitments of either direct or indirect private investment. Moreover, the storm front poses an obstacle to the very process of political development on which a free economy must ultimately depend. In order to illustrate these points I would like to point to one of the most "fortunate" of the borrowing countries, Mexico, which possesses abundant energy resources, has already passed through a period of rapid industrialization, and which borders on the U.S. The following section will indicate that even under the most favorable circumstances, the tradeoff between debt repayment and growth with democracy is becoming ever more acute. The recent earthquake only underscores this point.

__The Mexican Case__: Mexico has been one of the most notably circumspect performers in terms of austerity compliance to facilitate adjustment to its debt which is nearly one-third of the Latin American total. Until the past few months, its policies have been heralded by creditors as a model for the third world. While this has cost political capital for the de la Madrid administration and those in his government who have been "taking the hits" for adjustment policies that have reduced the growth of government spending, increased taxes and prices of public goods, cut the share of its deficit to GNP in half, and sharply devalued the exchange rate, Mexico until now has been able to continue its balancing act between debt repayment and social welfare. However even before the earthquake declining oil prices, faltering exports, and rising imports threatened this delicate balance.

__Mexico's Current Debt Service Squeeze__: It is now apparent that Mexico cannot even cover interest payments on the debt for 1985 without a major new injection of foreign borrowing or a severe drawdown on its existing reserves. While the earthquake may cost at least $1 billion more, the following estimates do not take that additional burden into consideration. After several years of adjustment which brought about the first decline in GNP in modern history, as well as a twenty percent cut in real wages and severely reduced real incomes for all social classes, 1984 showed a slight recovery which was followed by an acceleration of the econom in the first half of 1985. It quickly became apparent that this "growth-recovery" was having a severely detrimental effect on the country's trade balance. Non oil exports fell as domestic demand grew and the exchange rate lagged behind domestic inflation, while imports soared. The tight link between growth and the balance of payments was still there. Table 1 shows the impact of the recent recovery, as well as falling oil prices, on the country's ability to service its debt.

The following table supports recent statements of Mexico's finance minister that notwithstanding a continuing commitment to adjustment, even after the earthquake, the country will not be able to meet its dollar denominated obligations without dipping into its hard won foreign exchange reserves or acquiring new sources of external finance.

Table 1

A Projection of Mexico's Foreign Exchange Position 1984-1985
(All figures in billions of current U.S. dollars)

Central Bank Reserves Jan. 1, 1985 [1] 7.25 bill

Demand for Dollars		Supply of Dollars	
Imports [2]	14	Exports	22-23
		Oil [3]	14
		Non-Oil [4]	8-9
Trade Balance 8-9			
Interest on Foreign Debt	11 bill [5]	Other Revenues	3.25
Other Financial Services and Flows	.5	Tourism	1.0
		Interest on Public and Private Investments Abroad	1.5
		Border Trade	.75
Current Account -.25 to +.75			
Net Accumulation of Foreign Debt	1		
Current and Capital Account -1.25 to -.25			
Capital Flight (Errors and Omissions)	1.5		
Change in Central Bank Reserves Jan. 1, 1985-Dec. 31, 1985 -2.75 to -1.75			

Reserve Position as of Dec. 31, 1985 4.5 to 5.5

[1] This figure is the IMF estimate. Banco Nacional de Mexico estimates 7.5 bill.

[2] For the first five months of 1985 imports totaled 5.7 bill., which would project to 13.7 for the year. There was a slight upward trend in the first half, but the July devaluation from 230 to 290 pesos per dollar should have mitigated the rise.

[3] Oil exports totaled 5.8 bill. through May of 1985, which extrapolates to 13.9 bill. for a full year. The 14 bill. estimate in the table assumes a slight rise in exports offsetting a slight fall in the world oil price in the second half of 1985 (about 1.5 million barrels/day at about $25/barrel).

[4] Non-oil exports are the most uncertain category. They totaled 3.6 bill. through May, but fell sharply in the second quarter of 1985. Whether these exports exceed or fall short of the 8.6 bill. extrapolated total depends on the economic activity levels in the U.S. and Mexico's other trading partners, the effectiveness of the July devaluation and Mexico's anti-inflation efforts, and the behavior of real incomes and wages within Mexico. Maquiladora exports account for about 1.5 billion of this trade.

[5] Interest on the foreign debt is calculated on 96 billion dollars of debt at an annual interest rate of 2.5 percent over LIBOR (London Interbank Overnight Rate). By mid year this rate had fallen from over 13 percent in late 1984 to just over 10 percent. If rates stay low through year's end, Mexico could save about .5 billion in interest payments. Further softening of the oil market could negate these gains, though.

[6] In a similar exercise in September of 1983, the change in Mexico's international reserves was estimated at +.5 to +1.5 (See U.S. view of the Political-Economic Implications of Trade and Financial Interdependence with Mexico to be published in early 1986, a paper presented at a U.S.-Mexico Project sponsored conference on U.S.-Mexico Trade and Financial Interdependence at Stanford University). The actual reserve change was 2 billion, with the strength of Mexico's commitment to import restrictions and austerity being the only miscalculation.

[Note: The earthquake is expected to impose a direct foreign exchange cost in the neighborhood of $1 billion dollars, according to official sources. There has been an outpouring of private as well as governmental assistance to Mexico which will help to relieve this burden. However it may be expected that relief and reconstruction will have additional indirect effects both reducing exports and increasing imports; also such activities have in similar cases in the Americas had a significant positive impact on the price level, along with improved levels of wages and employment in the construction sector.]

Few Degrees of Freedom for Mexico: In order to determine the ability of Mexico to break out of the box it is in, as illustrated by the above projections, Table 2 looks at a number of alternative impacts on its debt service capacity including OECD growth. The reader can use this table to make alternative estimates of Mexico's foreign exchange position based on different assumptions. It shows that the country has few degrees of freedom to escape from the growth/debt constraint. For example, the pessimistic scenario of a further depressed world oil market ($22/barrel), little or no production response due to a fixed export platform (1.5 mill. b/d), rising world interest rates (LIBOR of 10.5 percent), a decline in OECD growth (to 2.5 percent), no major new peso devaluation, and domestic inflation of 60 percent would reduce reserves by an additional 1 billion (.4 + .1 + .25 + .125 + .15)in the fourth quarter of 1985, with disastrous consequences for 1986 and beyond. The most positive scenario would at best counteract the projected $1 billion earthquake foreign exchange cost without relieving the country's need for new capital just to cover interest costs.

Table 2
Sensitivity Analysis of the Foreign Exchange Market in Mexico

Variable	Change	Response (over 1 yr)
Avg. interest rate on foreign debt	1 percentage point	$ 1 billion[1]
Gross domestic product of trading partners	1 percentage point	$ .25 bill[2]
International oil price	1 dollar/barrel	$ .50 bill[3]
Real exchange rate	1$(i.e.400 pesos/$ to 404 or 396)	$ .06 bill[4]

[1] 1$ x 96 bill. = .96 bill.
[2] Assumes an income elasticity of demand for Mexico's exports of 4 (See the work of Jaime Serra and others).
[3] $1 x 540 million barrels/year = .54 bill.
[4] Assumes a price elasticity of demand for Mexico's exports of just over 1, and almost no price elasticity of import demand.

There is certainly a positive impact on Mexico from any improvement in U.S. and other OEDC growth. This is evidenced by point 2 above which has been used by international "supply siders" to argue for a "trickle down" approach to Mexican policy; "The best thing we can do for developing countries is to put our own house in order and grow rapidly, spurring our demand for imports", say such optimists. Unfortunately this position ignores two vital points - that the analysis above holds trade policy constant (as well as migration policy, Federal Reserve Board strategies, etc.) and that the U.S. may not be the best place in which to invest in the international comparative advantage scheme. The first point is both obvious and subtle; while it is clear that changes in trade policy could do more to help Mexico than even an unrealistically optimistic 1 percentage point increase in the U.S.'s long term growth, it is not as well known that tighter migration and interest rate policies feed back into the realm of international trade with strong and often unpredicted effects. For example, new restrictive migration legislation at this point would increase the pressure for job creation in Mexico, reduce wages there, cause U.S. and other capital to move offshore, and increase the pressure for Mexico to export, further worsening the U.S. trade balance. On the other hand, debt renegotiation toward a more equitable and feasible schedule of payments would ease the pressure to export and increase the capacity to import, reducing the U.S. trade deficit.

One variable that Mexico can control to some extent is its real exchange rate - the adjustment of its nominal exchange rate to different rates of inflation at home and abroad. A stable real exchange rate is achieved by continually adjusting one's exchange rate by the differential in inflation rates, such that a dollar purchases the same amount of a commodity in Mexico at the beginning and end of a period. When this amount is the same as that purchasable in the U.S., this is termed Purchasing Power Parity. Because of Mexico's need to export to service its debt, it must keep some degree of undervaluation of the peso so that Mexican goods are a "good buy" in dollars. Table 3 addresses the question of how well they have accomplished this in the recent past.

Table 3

A Purchasing Power Parity Exchange Rate for Mexico: Some Estimates

	1977	1981	1983	1985 (June)	1985 (yr end)
Actual rate (pesos per dollar)	22.8	23.7	144	228	320
Purchasing power parity rate (assuming 1977 to be "correct"	22.8	33.2	97.2	230.6	292.25
Overvaluation (negative sign indicates undervaluation)	0	40	-48	1	-10

Table 3 indicates that if exchange rates were in line in 1977, the slowdown in export growth in the second quarter of 1985 can be explained by the movement from substantial undervaluation to slight overvaluation of the peso prior to the July devaluation. It also indicates that the current level of mini-devaluation will not be sufficient to maintain undervaluation of more than 10 percent through the end of the year, the level many regard as the minimum necessary to maintain export incentives. It seems that the mini-devaluations have not altered the disruptive cycle of gradual overvaluation than large devaluation. The key fault of the new policy is the systematic underestimation of domestic inflation. We have stressed the importance of a stabilizing exchange regime because it is one of the few degrees of freedom which Mexico does have for growth and stability given the constraints of the debt. Moreover, such a regime along with greater assurance of convertibility would stem the outflow of private capital with which the right hand of the private sector offsets the the left hand of government austerity. Here is an important area for enhanced U.S.-Mexico cooperation, in which a commitment to short-term swap arrangements by the Fed and Treasury can facilitate more stable rules of the game for decision makers in both countries on which future investment must depend.

Mexico is No Longer a Special Case: The recent circumstances in Mexico bring its position much closer to that of other borrowing countries including Brazil, Argentina, and Venezuela. Even the smaller countries' problems are beginning to approximate those of their larger third world neighbors. For this reason conditions exist for increased commonality of advocacy, even though most of the governments have yet to provide any official endorsement for a debtor's cartel. But the handwriting is on the wall. U.S. and other OECD nations' strong endorsement of democratization makes it all the more important that these countries seek a dramatic new approach to the debt problem, an approach that in their view, and in the view of a growing number of outside observers, must sooner rather than later produce an actual or de facto reduction in the present value of outstanding obligations as well as a decline in debt service.

Fortunately there is considerable potential for recovery, growth, and democratization in the Americas. While some African and Asian countries are far more constrained by internal problems as well as external limitations, Latin America is a region which for the most part has important endowments of resources, human capital, and a disposition to develop. Moreover it is in the neighborhood of the United States and cannot be ignored by this country for reasons of our own national security and future prosperity.

The Impact on California of the Latin American Debt Crisis

by

Bill Brockenborough

Report Submitted to
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EXECUTIVE SUMMARY

The debt crisis in Latin America has struck a blow to three of the most beleaguered sectors of California's economy: manufacturing, agriculture and finance. Using trade statistics from the U.S. Department of Commerce, the following can be stated:

- In 1981, exports to Latin America provided 50,500 jobs in the state of California, both in industries which exported directly and in support industries used by exporting manufacturers. This figure represents 2.5% of all manufacturing jobs in the state in that year.

- Although 1981 exports to Latin America accounted for a small part of total production, the subsequent drop in exports accounts for a larger share of the drop in manufacturing employment. From 1981 to 1982, the drop in exports of manufactured goods to Latin America caused the loss of 14,800 jobs; this represented 19% of all jobs lost in manufacturing during this period. By 1983, Latin American export-related employment had fallen by 27,000 since 1981; this represents 28% of all jobs lost in manufacturing in those two years. Competition from Latin American imports caused by the debt may add another 10% or so to the job losses.

- In 1981, California's agricultural exports to Latin

America totaled over $322 million. This amounted to 11% of total state agricultural exports and 2.3% of total state production.

- o As with manufacturing, a drastic decline in a small sector accounts for for a large share of losses in all sectors. After adjusting for the effect of the strong dollar, exports to Latin America declined $68.7 million in 1982 and $64.2 million in 1983. The 1982 debt-related losses represent 15.8% of the decline in California farm income from 1981 to 1982.

Other aspects of the debt crisis are less easy to quantify, but are no less real. These include:

- o The debt crisis' effect on the financial health of manufacturers is understated by figures detailing loss of sale or jobs. This is because sales to Latin America typically have higher profit margins than domestic sales. American firms enjoy a number of marketing advantages in the region over Japanese and European firms, and the Latin American markets are less competitive as a result. One executive of a large electronics firm reported that in 1982, sales to Latin America were the only ones the company did not make at a loss.

- o Bank profits were directly affected by late payments from Latin American debtors, but the debt crisis also has hurt banks in an indirect manner. In particular, banks are now writing off large numbers of farming and shipping loans, and these two sectors have suffered from the drop in exports to Latin America. Moreover, as mentioned before, the effects of the latest recession on general industry were exacerbated by the debt crisis. The crisis itself, then, was responsible for some share of the defaults and dearth of new loans that banks experienced in the early 1980's.

INTRODUCTION

The United States' massive trade deficit is perhaps the most pressing economic concern in this country today, receiving daily attention in the media and giving rise to hundreds of pieces of legislation before the U.S. Congress. The strong dollar, though the most cited cause of this problem, is certainly not the only one. According to the "1985 Economic Report of the President," most of the trade gap can is due to the strong dollar and the low U.S. savings rate; however, fully one quarter of the trade deficit over the last five years can be attributed to two other causes. One is the rapid growth of imports due to the expansion in the U.S. economy since the 1981 recession; the other is the drop in exports due to the Latin American debt crisis.

This report analyzes the effects of this last, overlooked side of the trade deficit: the loss of markets in Latin America due to the massive dollar-denominated debt in the region. This report presents estimates of lost manufacturing jobs and farm income in the state of California due to the Latin American debt crisis.

The research for this report was conducted in two areas. The first was a analysis of U.S. government statistics on trade and the California economy. The second was a series of discussions with people in banking, manufacturing, technical services, and agriculture that gave a more subjective view of the problems in exporting to Latin America. These discussions provided the understanding necessary to make a meaningful analysis of the actual trade data.

In 1984, the Latin American nations had a total outstanding public debt of over $366 billion, an amount equal to 377% of their gross exports in the same year. Clearly, this enormous debt has had a major role in the disruption of exports to Latin America, a role separate from the strong dollar which has been cited as the root of America's trade deficit.

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MANUFACTURING IMPACTS

Exports are an important driver of industrial activity in the California economy. California ranks eigth among the states in the percentage of manufacturing jobs related to exports. In 1981, exports directly or indirectly accounted for 1 out of 7 California jobs in manufacturing. Growth in exports accounted for 20% of the expansion in California's industrial sector between 1977 and 1981.

Exports to Latin America have been a particularly important component of total exports, due to the composition of California industry. Transportation equipment, machinery, and electrical/electronic equipment are three of the five biggest industries in the state, they are the three biggest export industries, and all three are largely capital goods industries. Latin America, economically a rapidly growing region for the past 25 years, imports a disproportionally large share of American capital goods. Taking into account the unique structure of California manufacturing, Latin American exports generated 50,500 jobs in the state in 1981 (see Appendix 1 for details on this and other manufacturing statistics presented in this report.) This represents 2.5% of all manufacturing jobs in the state in that year.

Just as export growth accounted for a large share of manufacturing growth in the late seventies, export declines accounted for a large share of the decline in manufacturing in the early eighties. In 1982, Latin American export-related employment fell by 14,800; this represents 19% of all jobs lost in manufacturing in this period. By 1983, Latin American export-related employment had fallen by 27,000 relative to 1981 levels; this represents 28% of the difference in manufacturing employment levels between 1981 and 1983.

It may seem unbelievable that such a small subsector of California industry could be responsible for such large job losses, but this was not a typical case of gradual structural change. Latin American countries slashed imports from the U.S. by $19 billion in 1982 and another $7 billion in 1983. Using Lester Davis' oft-quoted estimate of 25,000 jobs per $1 billion of manufacturing exports, the seriousness of these declines becomes apparent.

THE PRE-CRISIS TREND

The United States' pattern of trade with Latin America over the last 25 years reflects the general economic relationship between the two areas. Latin America had become an region of explosive economic growth, rapidly moving away from a commodity-based to a more industrial-based economy. The United States in turn provided a source of intermediate and capital goods and a market for finished products. Statistically, Latin American exports grew at an annual rate of 9.9% from 1960 to 1981 (18.6% from 1974 to 1981,) with exports of manufactured goods growing almost ten times as fast as commodity exports.

This industrialization was fueled in part by imports. From 1972 to 1981, Latin America's imports grew at an annual rate of 8.8%. American manufacturers in particular benefitted from this, as imports from the United States grew 13.3% per annum in the same period. This growth in imports is often cited as the root of the debt crisis, as capital inflows were supposedly used to finance imports of nonproductive goods. A breakdown of imports from the United States does not bear this out; Latin American purchases of consumer, intermediate, and capital goods all grew at approximately equal rates. This across-the-board expansion of imports reflected the region's growth in both population and per capita GDP.

Therefore, comparing the post-crisis years to 1981 in a static manner does not reflect the total impact of the crisis. The austerity forced by the debt crisis interrupted a long and steady pattern of substantial growth in trade between the United States and Latin America.

STRONG DOLLAR OR DEBT CRISIS?

To what degree, though, are the manufacturing losses caused by the strong dollar which has hurt U.S. exports to other areas of the world? The interviews of export managers and international bankers conducted as part of the research for this project show that the appreciation of the dollar has had, for the most part, a minor effect on trade in manufactured goods with Latin America. The interviews indicate that the debt crisis is responsible for most of the disruption of these exports. The policies recently enacted by the governments of the debtor nations reveal that their massive obligations are their central consideration in matters of trade.

The interviews of business leaders yielded unique and essential insights into the situation currently faced by U.S. exporters. Their descriptions of the Latin American market demonstrate that very little of the drop in exports to Latin America is due to the strong dollar. Rather, the central banks of the debtor countries have severely restricted access to dollars, and potential buyers simply cannot pay for the American goods they want. Though Latin American customers, through local devaluations, dollar appreciation, and high tariffs, see grossly inflated prices for American goods, the demand for them is still unfilled.

In spite of the current economic crisis, the larger Latin American economies are still changing and growing modestly. Latin American businessmen do not want to reinvent the wheel, going through the same gradual modernization processes that industries in the United States have. Given a certain amount of capital, they would rather operate on a smaller scale with top-of-the-line equipment than on a large scale with outdated or obsolescent equipment and processes. Moreover, Latin American buyers believe that American products are the top of the line. In the words of an executive of an oilfield services company, "In Asia, price is king. For the Latins, price is not a driver. They are sold on technology. I just have to convince the customer that our equipment is the best, that we have the best service. The Norwegians may offer a better price, but we'll get the sale."

In short, executives in Latin America admire and seek to emulate American business, in much the same way that American manufacturers are now studying Japanese methods. In the words of one export manager with 23 years' experience in the region, "All of them read Business Week. They are all aware of the trends up here, and they want what's new and talked about."

The Latin American demand for business computers is a specific example of this general trend. As the manager of Latin American sales for a computer company said, "The 'computer revolution' that hit American business in the 70's has now arrived in Latin America." Latin American businessmen now want to modernize their offices, and they still demand American office computers even though tariffs may double their price. The governments of the debtor countries, anxious to conserve foreign exchange for debt service, use other, non-tariff, methods to stem the sales of American products. These include:

o Dollar restrictions: Latin American buyers cannot simply buy dollars from the central bank and pay for imports. In Brazil, for example, the local customer must present an invoice from the American firm, have it approved, and then wait as long as six months to get the dollars. Most American companies cannot extend credit for this length of time, so credit sales to Latin America have virtually stopped. Every company we contacted except one now requires the customer to have an irrevocable letter of credit approved by a U.S. bank for the full amount of the sale before shipment. In effect, almost all sales in the region are now made on a cash basis.

o Import licensing: Potential importers must qualify for licenses to sell in the country. One effect of this is to limit competition and raise prices. More important, importers often must maintain a presence in the country which will provide either dollars, jobs, or both. For instance, preferential licensing is granted to companies with manufacturing facilities in the country, or which sell through subsidiaries in which the local government holds an interest. This is the case with Mexico.

o Red tape: If high prices leave the buyer undeterred, the government may seek to discourage the importer with a Byzantine paperwork process. This is the case with Venezuela, which, because of its extremely low tariffs (around 3% for electronics,) does not appear to actively block imports. The real barriers, however, are not in the tariff schedules. An order of computers, for example, will be broken up into CRTs, printers, CPUs, and so on. Each subgroup must then pass through an elaborate bureaucratic process which can delay delivery by several months. Moreover, the subgroups will eventually reach the customer at different times, so that a usable system is not delivered until the last components clear customs. "The process is designed to exasperate importers," said a computer sales manager.

The appearance of these bureaucratic barriers coincides with the onset of the debt crisis. The export manager for an oilfield equipment manufacturer stated that "(the company's) business in Venezuela went from phenomenal to zero in six months" in 1982.

o Countertrade requirements: In Colombia, companies which import certain goods must earn 120% of the value of the goods through subsequent exports. Noncompliance is punished with prison terms.

o Outright bans: To conserve foreign exchange, many countries have launched import-substitution programs which foster new domestic industries. Where American products compete with these new domestic products, imports may be banned. Argentine construction contracts, for example, will now go to Argentine firms wherever this is feasible, irrespective of the cost. Said a vice-president for a U.S.-based construction services company, "The only jobs we can get (without financing from the Exim Bank or the Inter-American Development Bank) are those that are too big or too complicated for the local firms to handle, like nuclear plants."

Brazil now manufactures basic semiconductor chips and assembles personal computers from imported components. As a result, American manufacturers can no longer sell computers or basic chips in the country, even though their prices are as low as one-sixth of those charged by the Brazilian companies. The export manager of an electronics company stated that 95% of his chip sales to Brazil are now made through "Channel B;" the practice of selling to brokers who then smuggle the goods into the country.

Latin America countries have always had trade policies designed to inhibit imports, but the discussions with export managers indicate that the aforementioned barriers have become much more restrictive during the debt crisis. GATT's "International Trade 1982/1983" reports that trade barriers are the principal cause of the drop in the region's imports, along with austerity-induced contraction of demand. In the country-by-country review of trade conditions, the strong dollar is not once mentioned as a cause.

The foregoing should demonstrate that the decline in exports to Latin America has very little, if anything, to do with the appreciation of the dollar. The pressing need for dollars in the debtor countries has wreaked havoc with the flow of trade and closed many markets to American manufacturers.

JOB LOSSES AND CORPORATE PROFITS

The impact on the manufacturing sector is presented as a loss of jobs, rather than a loss of sales, because sector-by-sector figures for manufacturing output in California are not available. Benchmark levels of exports sales in the state are therefore impossible to determine from published data. Trends in state employment, though, are assumed to follow trends in national sales, so sales should be impacted to the same degree as employment. However, the percentage loss of jobs (and presumably sales) understates the effect on the financial health of exporting companies. The interviews of American export managers shows that profit margins on sales to Latin America have historically been high. Because of these high profit margins, the percentage loss of profits due to the crisis is higher than the percentage loss of sales.

This phenomenon of higher profit margins is related to the Latin American preference for American goods noted above. According to the executives interviewed, American firms enjoy other advantages in the region, including:

o American firms have the longest history of involvement in the region. Many have been exporting to Latin America for over 25 years. These established American firms therefore have the knowledge and the connections to make high margin sales.

o Latin American markets are difficult for newcomers to break into, in most cases. Latin American industrial companies tend to be conglomerates, so the market for capital or intermediate goods may consist of only a few large companies. These companies already have long-standing ties to American suppliers. Moreover, new entrants are discouraged by the import licensing mentioned before.

o Marketing consumer goods is easier for American companies, because Latin America is much closer culturally to the United States than it is to Europe or Japan. As an executive of a Latin American national bank put it, "Even in the remote cities, children wear t-shirts with English slogans, drink Coca-Cola, and if the family has a television, watch 'Dallas.'"

Japanese and European firms simply are not able to compete with American companies the way they do in other markets. In this less competitive atmosphere, American firms are able to earn higher profits. For this reason, sales to Latin America are more important than they seem to be. One executive of an electronics manufacturer said that although Latin America accounts for only 3% of the company's sales, the percentage contribution to profit of these sales is "much higher." The same executive reported that in the recession year of 1982, sales to Latin America were the only ones the company made at a profit.

IMPORT COMPETITION

Another way in which American manufacturers have been hurt by the debt crisis is through increased competition from Latin America in the domestic market. The pressing demand for dollars has forced the debtor nations to change plans for development and pour resources into industries which can earn foreign exchange through exports.

Brazil in particular has fostered its export industries, even going so far as to subsidize shipping to lower prices and increase sales. Between 1980 and 1983, Brazilian exports of paper to the U.S. rose 50.1%; shoes, 73.8%; and steel, 61%. In 1984, Brazil posted a whopping $5.2 billion trade surplus with this country.

Brazil's large trade surplus with the U.S. has not gone unnoticed in Congress; a bill sponsored by Representatives Richard Gephardt, Dan Rostenkowski, and Senator Lloyd Bentsen would slap a 25% surcharge on all imports from Japan, Taiwan, South Korea, and Brazil-- all of which run large trade surpluses with the U.S.. The bill has over 100 cosponsors in the House.

Brazil, though, stands out as a unique case among these four countries. The other three, Japan in particular, have high savings rates which have turned them into giant piggy banks. Their surpluses of savings over investment become capital outflows which allow for surpluses in trade. Brazil, on the other hand, has a low savings rate and actually suffers from a large amount of capital flight. Its massive trade surpluses are not an outgrowth of its internal capital markets. The flood of Brazilian goods into the United States is caused by the country's need to service a $104 billion external public debt.

Much of the increase in Latin American exports to the United States can be explained by the strong dollar. However, some of the increase can only be described as "dumping," a subsidization of exports to earn foreign exchange. The case of Chilean copper exports illustrates this point.

The inflation-adjusted price for copper in Chilean pesos actually fell slightly between 1981 and 1983. However, the volume of Chilean copper exported to the United States rose 50% in this period. Falling production costs did not cause this phenomenon; the scarcity of new capital in this period could only have raised costs for the capital-intensive industry. Rather, this backward-bending supply curve is a result of Chile's debt burden. As copper prices fall, more must be exported to generate the fixed amount of dollars needed for debt service.

In the meantime, American copper mines become less able to operate profitably. At the end of 1983, U.S. copper mines were running at 55% capacity.

Copper is perhaps the only case where exports increased as prices in the local currency actually fell. However, a comparison of Latin America and the rest of the world indicates that Latin American exports are driven by subsidies as well as currency rates. Latin currencies, after adjustment for inflation, have depreciated less than half as much as the trade-weighted basket of currencies for all the world since 1980. However, Latin America has increase its share of U.S. imports by 15% in this period.

Imports from Latin America were $4.5 billion higher in 1983 than they would have been had they expanded at the rate of all other imports. There has been no definitive estimate of the job losses caused by import competition, so the employment effects of this surfeit of Latin American imports is hard to assess. A dollar of imports does not replace a dollar of domestic production; imports can lower the cost of inputs to other sectors and actually raise employment. However, the largest gains were posted in industries which compete head-to-head with troubled American industries: steel, copper, shoes, textiles, and paper. These imports certainly caused some job displacement.

For a "back-of-the-envelope" estimate, assume that every dollar of these extraordinary Latin American imports replaced half a dollar of domestic economic activity. Once again referring to the estimate of 25,000 jobs per $1 billion of manufacturing production, this gives an estimate of 56,000 jobs lost nationally through debt-induced imports. This adds about 10% to estimates of jobs losses from loss of exports only.

INDIRECT EFFECTS ON BANKS

Banks have been hurt by the crisis; late payments from some debtor countries and additions to reserves to cover the increased risk of default have both cut directly into bank profits. However, banks have been hurt indirectly as well in the following ways:

o Banks have been reeling from the slump in shipping; U.S. banks alone may have as much as $20 billion in exposed maritime loans. The

Latin American debt crisis has contributed to this problem. First, shipping to the region became less profitable when Latin American countries began to run trade surpluses; many ships, lacking freight to carry south, would make that half of the trip empty. Also, the debtor countries have become more insistent that their exports are carried on the ships of their own flag fleets.

All of this has caused a shakeout in Latin American shipping. At present, only two steamship lines handle Latin American trade, and one of these is a newcomer which established itself there in the last two years by taking over the trading rights of less healthy lines.

o Another problem area for banks has been the growing number of nonperforming agricultural loans. As of 1983, 40% of the "problem banks" being monitored by the FDIC were farm banks (institutions where agricultural loans compose at least 25% of total assets.) The large losses of farm income noted below could only have exacerbated this problem.

AGRICULUTURAL IMPACTS

As with industry, exports provide a large share of California's agricultural revenues. Among the states, California ranks third in total agricultural exports. In 1982, 21% of the state's farm sales were exports.

Latin American exports are an important component of total exports for many commodities. In 1981, Latin America accounted for 20% of all wheat exports, 32% of all dairy exports, 34% of all vegetable exports, and 51% of all cottonseed exports. All told, Latin America accounted for 11% of California's agricultural exports in 1981. Exports to the region provided 2.3% of the state's farm income in that year.

As with manufacturing, the drastic decline in this small portion of the sector accounted for a sizable fraction of the sector's losses. Agricultural exports to Latin America fell much more than exports to the rest of the world, dropping by 37% from 1981 to 1982.

After adjusting for the effects of the strong dollar (see Appendix 2.) California's agricultural exports to the region dropped $68.7 million in 1982 and remained at this level in 1983. This debt-related drop in exports to Latin America accounted for 16% of the total drop in California farm income from 1981 to 1982.

APPENDIX 1
Manufacturing Data and Methodology for Determining Job Losses

NOTE: In this report, the term "Latin America" refers to the nations Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica, Mexico, Colombia, Venezuela, Ecuador, Peru, Bolivia, Chile, Brazil, Paraguay, Uruguay, Argentina, Panama, Haiti, and the Dominican Republic.

To determine, for each industry in California in 1981, the employment directly generated by exports to Latin America, the following information was used:

1) The percentage of jobs in that industry in California created directly by exports to all areas. This is from the 1982 ITA State Export Series.

2) The percentage of exports in that industry which go to Latin America. This is from the U.S. Department of Commerce trade records.

These two items are multiplied to get the percentage of California employment in each industry directly generated by exports to Latin America. There are two basic assumptions implicit in this method:

o There is, in all industries, a one-to-one correspondence between output at the margin and employment at the margin; i.e., a factor accounting for 5% of sales also accounts for 5% of employment. (I say "at the margin" because the ultimate result here will be figures for jobs lost.) This is reasonable so long as the industry is not an extremely capital-intensive one (such as agriculture,) where relatively large fluctuations in output may have no effect on employment. Barring this case, the assumption is actually conservative; workers at the margin are less productive than average, and thus employment change at the margin is greater than change in output.

o A broad class of manufactured goods can be treated as a commodity. Irrespective of the actual final destination of goods from a given locale, if 20% are exported nationally, then 20% of the locale's output is assumed to be exported. This may be a little presumptuous in the case of a single city or factory, whose specialized output may not mirror national trends. However, with a large, diverse segment of the economy such as California, the assumption is reasonable.

The resulting figures are called "direct employment," the employment generated by the production of goods which are themselves exported. Nearly as important is "indirect employment," the employment generated by the demand for inputs in exporting industries (the steel and copper put into a motor, for example.) The indirect employment generated by exports to Latin America is calculated with the following information:

1) The percentage of jobs in that industry in California

indirectly created by exports to all areas. This is from the 1982 ITA State Export Series.

2) The percentage of aggregate exports nationwide which go to Latin America. This is from the U.S. Department of Commerce trade records.

As before, these two items are multiplied to get the percentage of California employment in each industry indirectly generated by exports to Latin America. The assumptions outlined above are implicit here, as well as one other:

o Indirect employment is determined by the percentage of aggregate exports to Latin America, rather than the percentage for the particular industry. Indirect employment in steel, for example, does not depend on steel exports. It depends on the exports of all product which use steel. This is approximated by the aggregate percentage of exports which go to Latin America, which was 17% in 1981. Therefore, given that a certain number of jobs in steel in California are indirectly related to exports, 17% of these indirect jobs are due to trade with Latin America. This, though, is only true if the composition of exports to Latin America is identical to that of the rest of the world. This is certainly not true-- Latin America imports more capital and intermediate goods and less food than other areas-- but this method is still useful for estimation.

In view of these qualifications, the numbers presented are not definitive. Rather, they are meant to be reasonable estimates. There is no reason to believe that they are grossly inaccurate in one direction or another.

TABLE 1
Benchmark figures for California employment generated by exports to Latin America.

Category	% of 1981 exports to L.A. (national)	Total jobs in Ca. due to exports (thousands)		Total Cal. jobs attributable to L.A. exports in 1981 (thousands)	
		dir.	indir.	dir.	indir.
Transportation eqp.	16.5	48.4	8.5	8.0	1.4
Non-elec. machinery	19.3	49.4	13.7	9.5	2.3
Electric & electronic	18.8	49.3	18.0	9.3	3.1
Food & kindred prods.	15.5	6.5	3.4	1.0	.6
Instruments	15.9	15.2	2.3	2.4	.4
Petroleum and coal	6.9	.7	.8	-	.2
Chemicals	20.1	4.7	3.9	.9	.7
Metals	26.0	8.9	17.7	2.3	3.0
Misc. manufacturing	16.5	3.8	.4	.6	.1
Paper & pulp	18.9	.9	2.9	.2	.5
Rubber & plastic	25.0	2.8	4.2	.7	.7
Lumber	4.7	1.9	3.2	.1	.5
Others not listed	19.4	3.1	8.1	.6	1.4
Totals	17.0	195.6	87.1	35.6	14.9

Therefore, in 1981, exports to Latin America accounted for 50,500 manufacturing jobs in California, or about 2.5% of all such jobs in the state. This is used as a benchmark figure.

Changes in export employment are estimated by changes in exports from each industry (see Table 1.) If exports in a given industry in a given year are 10% lower than in 1981, direct export-related employment is assumed differ from the 1981 level by the same percentage. These calculations appear below. They are by nature slightly conservative, since (as stated previously,) workers at the margin are less productive than average. Indirect employment, on the other hand, will fall approximately at the rate of decline of aggregate exports, irrespective of the sector. Again, this is because the products of indirect employment are diffused throughout the economy and not tied to movements in any single industry.

Below, the benchmark employment figures are multiplied by the export losses to get approximations of job losses:

TABLE 2

Category	Jobs lost in each year (thousands)					
	1982		1983		1984	
	dir.	indir.	dir.	indir.	dir.	indir.
Transportation Eqp.	3.46	.38	5.25	.66	5.16	.58
Non-elec. machinery	2.49	.62	5.84	1.09	5.34	.95
Electric & electronic	1.88	.84	4.24	1.46	1.43	1.28
Food & kindred prods.	.44	.16	.30	.28	.45	.25
Instruments	.69	.11	1.39	.19	1.19	.17
Petroleum and coal	-	.05	-	.09	-	.08
Chemicals	.21	.19	.32	.33	.22	.29
Metals	1.00	.81	1.60	1.42	1.57	1.24
Misc. manufacturing	.15	.03	.28	.05	.25	.04
Paper & pulp	.03	.14	.06	.24	.05	.21
Rubber & plastic	.21	.19	.29	.33	.28	.29
Lumber	.03	.14	.05	.24	.05	.21
Others not listed	.16	.38	.29	.66	.25	.58
Totals	10.75	4.04	19.91	7.04	16.24	6.17
Direct + Indirect totals	14.79		26.95		22.41	
Drop in employment in Ca. manufacturing from 1981	77.3		95.5		not available	
L.A.-related drop as a percentage of overall drop	19.1%		28.2%		-	

A limited amount of the last type of analysis (L.A.-related drop as a percentage of overall drop) can be done on a sector-by-sector basis. For example, employment in manufacturing transportation equipment fell by 11,400 from 1981 to 1982. By the estimates above, the 3800 lost jobs attributed to the decline in L.A. trade represent 33% of this total. Likewise, L.A. losses account for 36% of the loss of jobs in non-electric machinery. These statistics cannot be calculated in this straightforward manner for each sector; electric and electronic manufacturing posted an overall employment gain in the same period, so assigning a percentage of losses to Latin America is not possible.

This final type of analysis is the type most subject to error. The point, however, is not to pin an exact amount of some year's unemployment on the debt crisis; it is to show the magnitude of the crisis' effect on the manufacturing sector. Jobs lost to the decline in exports to Latin America were not absorbed elsewhere in the manufacturing sector. For most industries during the period examined, there were no increases in domestic sales, or exports to any particular world area, which would soak up the Latin American job losses. The job losses calculated made a very real contribution to unemployment.

APPENDIX 2
Agricultural Data and Methodology for Determining Losses

Below, the losses of income to California farmers are calculated. This is done with the following information:

o The total amount of each commodity group exported by California farmers in each year. This information comes from the U.S. Department of Agriculture's Foreign Agricultural Trade of the U.S. (FATUS.) Since agricultural goods are commodities, the FATUS report defines a state's exports as the product of the state's share of national production and total national exports, for each commodity group.

o The share of each commodity group's exports which go to Latin America. This information is from the Department of Commerce's trade records.

The product of these two numbers is the amount of each commodity produced in California which was exported to Latin America. Again, this is true because agricultural goods are commodities.
However, since these goods are commodities, their sale has been affected by the appreciation of the dollar as well as the shortage of dollars in Latin America. Unlike American manufactured goods, American agricultural goods have no marketing edge over those from other areas. The adjustment for the strong dollar is made in the following way:

1) Calculate the percentage drop in sales of agricultural goods to all areas except Latin America. This is assumed to be caused by the strong dollar.

2) Repeat for Latin America only. The drop in sales beyond the drop to the rest of the world is assumed to be caused by non-dollar effects, i.e. the debt crisis.

There are some problems with this method. First, the drop in sales of some goods (dairy products and raw cotton) was actually smaller for Latin America than for the rest of the world. Using the simple foregoing method, this would imply that the debt crisis tended to increase the sale of these goods. This is of course ridiculous. However, the numbers involved in these aberrational cases are quite small, and amount to no more than statistical noise.

All data are in dollars for the year of the table, except for the net changes, which are presented in 1981 dollars.

TABLE 3
California's Exports of Various Commodities to Latin America
for 1981 through 1983

1981

(thousands of dollars)

category	total ex. to LA	total to all areas	LA/world	total Ca. ex.	Ca. ex. to LA
Fruits	114,091	1,614,362	0.07	760,100	53,718
Cotton	11,055	2,298,977	0.00	628,400	3,022
Nuts	15,928	368,620	0.04	465,100	20,097
Wheat	1,562,456	7,843,960	0.20	249,600	49,718
Vegetables	449,806	1,331,439	0.34	291,600	98,513
Rice	90,884	1,526,385	0.06	382,800	22,793
Feed grains	769,906	8,327,099	0.09	55,700	5,150
Dairy	82,956	258,181	0.32	35,600	11,439
Cottonseed	105,550	206,645	0.51	65,500	33,456
Meats	133,699	1,215,213	0.11	44,000	4,841
Poultry	100,486	536,799	0.19	50,800	9,509
Hides	86,680	699,601	0.12	27,000	3,345
Fats & oils	411,529	1,628,992	0.25	27,100	6,846
Totals	3,935,026	27,856,273	0.14	3,083,300	322,447

1982

(thousands of dollars)

	total ex. to LA	total to all areas	LA/world	total Ca. ex.	Ca. ex to LA	crisis adj net ch
Fruits	86,097	1,483,355	0.06	700,300	40,647	-8,895
Cotton	11,519	2,003,435	0.01	488,800	2,810	3,521
Nuts	9,487	294,961	0.03	359,200	11,553	-4,235
Wheat	1,221,528	6,675,574	0.18	238,000	43,550	-2,683
Vegetables	211,603	937,344	0.23	290,900	65,670	-21,874
Rice	23,348	997,254	0.02	257,200	6,022	-8,982
Feed grains	222,992	5,852,413	0.04	38,400	1,463	-2,228
Dairy	73,736	297,157	0.25	59,600	14,789	5,671
Cottonseed	82,981	214,063	0.39	54,000	20,933	-25,554
Meats	126,915	1,234,430	0.10	52,400	5,387	163
Poultry	46,768	354,982	0.13	37,900	4,993	-1,945
Hides	68,109	778,177	0.09	32,900	2,880	-855
Fats & oils	393,163	1,388,445	0.28	27,900	7,900	-800
Totals	2,637,500	22,511,590	0.12		-106,788	-68,695

1983

(thousands of dollars)

	total ex. to LA	total to all areas	LA/world	total Ca. ex	Ca. ex. to LA	crisis adj net ch
Fruits	36,724	1,447,591	0.03	690,400	17,515	-30,044
Cotton	27,801	1,854,270	0.01	432,300	6,481	3,483
Nuts	3,835	252,940	0.02	327,000	4,958	-8,446
Wheat	1,161,653	6,235,255	0.19	193,000	35,957	-3,068
Vegetables	88,436	743,322	0.12	199,600	23,747	-46,509
Rice	75,458	925,603	0.08	207,800	16,940	6,524
Feed grains	1,003,465	6,677,459	0.15	36,700	5,515	-370
Dairy	145,271	316,887	0.46	70,800	32,457	21,414
Cottonseed	52,721	107,878	0.49	33,800	16,518	-1,416
Meats	66,593	1,209,334	0.06	56,300	3,100	-1,877
Poultry	30,940	326,219	0.09	33,300	3,158	-3,091
Hides	53,948	806,711	0.07	37,200	2,488	-1,375
Fats & oils	407,921	1,391,223	0.29	24,500	7,184	533
Totals	3,154,766	22,294,692	0.14		-162,438	-64,243

Column abbreviations:

Total ex. to LA: The total amount of the commodity exported from the United States to Latin America.

Total to all areas: The total amount of the commodity exported from the United States.

LA/world: The fraction of total exports of the commodity which went to Latin America.

Total Ca. ex.: The total amount of the commodity produced in California and exported to all destinations. This is from FATUS.

Ca. ex. to LA: The derived figure for California production of the commodity which was eventually shipped to Latin America.

Crisis adj. net ch.: The change in California's exports of the commodity to Latin America, after adjusting for dollar effects and inflation.

Senator **Mathias**. Let me pick up on that point. You also said that Congress must be involved. And obviously, in any kind of workout like the British-American model, Congress would have to be heavily involved.

You said that Congress reflects the opinion of the rank and file in this country, and I hope that is true and I really believe it is true. I think that Congress is in fact a representative body and that as tremors of anxiety go through the general population, they are very promptly reflected in Congress.

Having said all that, what about the kinds of developments which militate against strong support in Congress? One possibility—it hasn't really come to fruition yet, but one possibility is the Castro initiative.

You create a debtors' cartel in South America. And you simply repudiate the debt, or repudiate the interest payments, or some part of it, or otherwise operate in a highly aggressive and inflammatory manner.

Now, as I say, that hasn't really gained much speed so far. Do you see any danger of a debtor cartel developing? I think that would have a great impact on the congressional reaction to solution.

Mr. **Reynolds**. First of all, it is very unfortunate and certainly true that Castro made that speech at that conference in Havana. But he is paying his own debt, and everybody knows it.

He has got two faces, really. One face as a negotiator with the financial community is straight-arrow, and the other is his political face. And my guess is that anybody could understand that kind of rhetoric.

The question is whether it is getting an echo in the region.

Senator **Mathias**. That is the problem.

Mr. **Reynolds**. Yes, it is getting something of an echo in some corners in what they call the populist and nationalist and sometimes left-wing corners of all the countries. Not very big echoes, as a matter of fact surprisingly small, in terms of what you would expect at this point. Because populism is very appealing and very attractive.

The problem is, what is the discount rate that politicians apply to policies which are very clearly not going to work in their interests over a very short period of time? Can they get by with stopping for a little while?

But all of the commercial relations, all of the links--which I think Professor Fishlow and others have been talking about—the web of interdependence which whether we like it or not exists, affects their own political career and future.

Why is Castro paying his debt? Why is the Soviet Union talking about good performance on the part of debtors to the West, not just to them? Because we all sink or swim together. And any responsible politician knows that.

On the other hand, if you are trying to go out and get votes, if you are trying to get an echo from the rank and file—in some countries where the rank and file is like many people were in our big cities in the past—then you go out and be demagogic.

But basically, every leader in Latin America, from the South to the North, knows that that is not a way out. So what I would say is not a cartel in the terms that you are talking about, but certainly more coordination. You are going to see more coordination and more political muscle applied.

Senator MATHIAS. I understand what you are saying, but I think there is certain inherent political dangers as far as the ability to mold a policy within the United States on the British-American model.

Peter Jones.

Mr. JONES. Two comments. One, people in Washington used to say if there wasn't a Fidel Castro we would have to invent one.

The Alliance for Progress was in large part a congressional and administration response to the Castro threat. Whether the fact that Castro is stirring the pot by urging people to cancel the debt, thereby adding a political East-West dimension to the problem, might not help get the attention of at least some in Congress or not, I don't know.

But in the past, it has sometimes worked that way and should do so in this case.

My second comment: This morning you asked each of us to try and relate this back to the American voter and their elected representatives in Congress and what might get their attention.

One of the Nation's leading authorities on migration from South American, Central America, and Mexico into the United States is sitting here, Wayne Cornelius. He has done more work on this than anybody else. And I would like very much to hear from him on it.

Mexico and the rest of Latin America gets in deeper and deeper trouble. What impact is that going to have on migration into the United States?

Senator MATHIAS. I think he is going to comment on that basic question anyway. So we will ask him to add on the subject of migration.

Mr. CORNELIUS. I am just going to point out that there are many way stations between a passive acceptance of the existing rules of the debt renegotiation game on one hand, and repudiation on the opposite extreme.

As I pointed out in my statement, I think there is a growing constituency in Mexico for some more moderate alternatives, certainly some kind of arrangement to put a cap on debt service payments as a percentage of export earnings.

That of course is the alternative that Peru has embraced. Thus far, I think it is significant that no other Latin American country has yet formally embraced it as an official policy objective. So I've got to see it in terms of sitting out there on a limb by himself to date.

But I certainly expect in the context of Mexico that steadily building political pressure to break out of the existing cycle and reschedulings and pursuit of new funds is simply to maintain the capacity for regular debt service. I don't think that that is any longer a politically viable course in Mexico.

And some of the more radical alternatives I think are now a serious part of political discourse in the country.

Senator **Mathias**. But will the formulation of those new policies take into account the problem that Professor Reynolds raises that Congress must be part of any U.S. contribution to the solution?

If those policies are viewed to be abrasive or intransigent that can jeopardize the kind of broad moderate policy that might otherwise flow from Washington?

Mr. **Cornelius**. I think there is real sensitivity to that problem on the part of people at the highest levels in the Mexican Government. And they have explicitly rejected a confrontational approach to the problem as recently as the President's state of the nation address in September in which it was widely rumored that he would take a more abrasive confrontational stance on the issue. And he failed to do so.

But he clearly opened the door to a more aggressive round of negotiations with the commercial banks with the object of reducing said debt service requirements. And I think that that is clearly the way that the Mexicans will try to go. And they will push as hard as they can until they meet total resistance on the part of either the creditors or the United States.

Because they are being pushed in that direction inexorably by the pressures that have built up since 1982. They must politically adopt a more aggressive stance in the face of these pressures.

Senator **Mathias**. Our time is really up for this panel. I have one other question that I think it is important to ask under this heading.

And that is, many developing countries have shifted the emphasis of their economies to exports in order to earn the foreign exchange to service their debts.

Given that their real survival now depends on trade, why has there been so much reluctance in these debtor countries to participate in a new round of trade negotiations?

Mr. **Fishlow**. I think, Senator, one of the principal countries that has been responsible has been Brazil. And I think the attitude of the Brazilian Government is that this is one of the few ways it can try to elevate the problem of debt to the same level as the trade problem.

It wants to see the two considered together, rather than separately. And in particular, I think that the way of understanding the Latin American view at the moment is not in the context of the debtors cartel, but simply elevating the issue politically.

And I think they have felt up to now that the issue has been dealt with technocratically. That is has been dealt with not as something that is a matter of concern to Congress, but rather of concern to the International Monetary Fund or of concern to——

Senator **Mathias**. It has been dehumanized to a certain extent.

Mr. **Fishlow**. And I think that the notion that they have an opportunity in the context we have got to point out the inexorable relationship between their own ability to deal with the debt as well as the trade issue does go a long way to explaining that reaction.

Senator **Mathias**. I am reluctant to call this panel discussion to a halt. But I am afraid I have to do it in order to prepare for the next two panels.

Professor Cornelius, we really didn't get the full impact of your knowledge on the migration questions.

Mr. **Cornelius**. Another day.

Mr. **Jones**. It is in his paper.

Senator **Mathias**. If you want to add to what is already in your statement, we would be happy to include any further statement in the record. And I make the same offer to the other witnesses.

Thank you very much.

Our next panel is on the subject of "Trade Policies and Practices of OECD Nations." And it will include Prof. Laura Tyson, Department of Economics of the University of California at Berkeley, and Mr. Jones again and Paul Slawson.

Mr. **Jones**. Mr. Slawson is out of the country.

Senator **Mathias**. Mr. Jones advises that Mr. Slawson will be unable to be with us. So it will be Professor Tyson and Mr. Jones.

Mr. **Jones**. I would like to make an opening statement.

Senator **Mathias**. Certainly.

STATEMENT OF PETER T. JONES, GRADUATE SCHOOL OF BUSINESS ADMINISTRATION, UNIVERSITY OF CALIFORNIA, BERKELEY

Mr. **Jones**. Your next panel is on the same U.S. growth and debt crisis, with special emphasis also on trade policies.

What you have heard all morning and this afternoon is the gravest danger of this whole debt crisis to U.S. growth, the financial system and our national security interests, is still too little too late.

And there are still too many people in the administration, among the administration's supporters on the Hill, and in some of the large and small banks that believe that if you leave it to the private sector alone, it will work out for the better.

You have also got a number of people in the administration still and in the Congress who are opposed to bailing out the American banks on one side, and another group that are opposed to bailing out these debtor developing nations on the other side.

Those forces still run a very serious risk of combining to have an impact on this whole question of too little too late.

One of the things I have attempted to do, since you reminded us that we are speaking directly to the Congress and through the Congress to others in Washington as well, is to try and figure out if there was one single message or idea that could be brought back to President Reagan and those people who feel it is safe enough to leave it to the forces of the marketplace, what would that message be.

And that message, Senator, I believe is the following. Thus far, President Reagan and his administration have demonstrated considerable political courage and success in containing this debt problem and U.S. protectionism, especially in view of the rising power of protectionism worldwide.

And I would say that was true, even though they have brought some of the protectionism on themselves with the large budget deficit. But total exports, after falling 25 percent between 1980 and 1983 in the United States, have now become to climb again. And exports are also climbing again elsewhere in the world as well.

So at least in that sense, at the moment we have once again trade between the nations capable of continued growth.

A favorable judgment of history, and with it one form of positive immortality, is a most important goal of any presidency. And so far during this President's regime, since much has been done to strengthen America's defense and economy and America's own self-confidence, I would say that today if you could stop the clock—just stop right here—history would probably give a net net favorable report on the Reagan administration.

But the key message to the Reagan administration and the President himself is that this was also true of President Hoover and it was also true of President Johnson. Both scored very well in the first parts of their time in office. And then they both blew it.

And they blew it for lack of ability to really understand massive sea change and for lack of will and capacity to change course to cope with such sea change.

In the first case, a worldwide depression and in the second case, the Vietnam war, totally destroyed the net favorable balance sheet history would otherwise have drawn on both Presidents.

It is my judgment, Senator, that a similar risk now confronts President Reagan concerning his own role in history with regard to the great issues surrounding America's vital stake in the debt, development, and democracy of the Third World.

Because of the capacity of these issues for grave mischief with the international financial system, U.S. national security and U.S. international competitiveness, the road taken—or not taken—in dealing with these issues could well determine history's final net judgment of Ronald Reagan.

And you, Senator Mathias, have once again been ahead or your time and most of your colleagues at both ends of Pennsylvania Avenue in recognizing that this is so. I know first hand how long and tirelessly you have worked to reduce the risks of disaster and bring about mutually beneficial solutions to these problems.

For this, our Nation, our hemisphere and the world at large owe you much gratitude for what you have done to help key people and the public understand that there is a clear and growing danger that this debt problem can get seriously out of hand.

Now, we must ask, is this too dramatic? There is experienced conservative authority to the contrary. Paul McCracken, former Republican chairman of the Council on Economic Advisers, is a fellow member of the Executive Committee of the bipartisan Bretton Woods Committee we discussed this morning.

In a lengthy meeting we had recently with Treasury Secretary Jim Baker, McCracken said, quote:

> I am not an alarmist, Mr. Secretary, but the recent decline in the availability of credit in important segments of the international economy in today's context is reminiscent of the situation that prevailed in the late 1920's. This makes it all the more important that we act in timely fashion to insure that adequate financial mechanisms are in place to prevent avoidable fears and disruption from occurring.

Every member of the Bretton Woods Committee at that meeting with Baker echoed those sentiments. We also said that given the concurrent pressures for more protectionism, if you couple the drying up of credit with a return to Smoot Hawley type high trade barriers, you could get a doubly dangerous twin phenomena which feed on each other and increase the risk of disaster.

As we have heard all day today, there is a growing consensus that voluntary credit flows from private banks over the next 3 years will not be adequate to do one essential part of the total job, nor will export earnings.

We have also heard from Phil Habib and in Washington you have heard from Henry Kissinger, Reardon Roett, and others that the political and national security risks to this Nation and to the Latin American debtor nations themselves also are unacceptably high.

If we think that Central America, Senator, today is a problem, think about Central American-type conflict and conflagration transferred to the Andean Region.

There is one other risk that is not being discussed very much on this issue, which is the damage that this continued debt crisis would do to U.S. competitiveness internationally.

As long as our friends in Japan and the new Japans are, as we said today, investing 50 percent more than we, turning out 50 percent more engineers than we with half the population, turning out better products, turning out more citizens competent in international business and foreign languages, we are going to have competitive difficulties even if the dollar comes down.

But there is one part of the world where we have major competitive advantages, and that is Latin America. And we are throwing away those advantages.

As a general rule: A larger portion of any increased availability of foreign exchange for imports in Latin America will be spent in the United States for U.S. goods and services than in any other country in the world.

But what are we doing about it? Very little, indeed. And as Clark Reynolds said, if this were England in the days of the Marshall Plan, we would treat this quite differently.

There are Panglosses in Washington, some of them still in the administration, that say all is right with the world, everything is for the best and the invisible hand of the marketplace will do the job.

The question is, is that an acceptable risk to run? And the answer is, not if you understand the third law of Latin thermodynamics.

Senator, we haven't yet discovered the first and the second law. But the third law of Latin thermodynamics is: After 3 years of austerity, everything blows.

And there is both historical and empirical evidence to support that fact.

Senator MATHIAS. That is a very human rule. Anybody who has tried going on an extended diet finds that out.

Mr. JONES. Exactly, exactly. And it is the same thing. And for us to think we can muddle through on the basis of leaving it primarily to the private sector, is foolhardy. Now, why is it foolhardy? Not because we can forecast with certainty that we won't muddle through. Not because we can tell you just how high the risks are.

It is foolhardy for another reason. And that is because, to simply rely on private sector market forces would violate what we have also discovered to be the first law of Presidential prudence. What is that?

That is, don't bet your country or your Presidency primarily on the invisible hand of the private sector operating under the discipline of the marketplace to muddle through for you, especially when:

One, private sector interests are narrower than yours and different from yours;

Two, their capacity to handle the problem is substantially less than the solution requires and much less than your full capacity combined with theirs; and

Three, most important, if it fails, your country for a spell and your Presidency for good will be finished.

One of the things businessmen will tell you, all of them, is that one of the laws of chief executive survival in major companies is that you don't bet your company on any treble damage antitrust suit where you could be liable for industry-wide damages which could wipe out your company.

No matter how favorable the odds of winning, no matter how good the prospects of muddling through, you don't bet your company. You reduce or eliminate those risks. And there has almost never been a horizontal price-fixing, treble-damage case for a major company that has gone to conclusion in litigation for that reason.

You also don't bet your family by not taking out life insurance. Our message to President Reagan is: You don't bet your family by not taking out life insurance, you don't bet your company on antitrust, then please, for God's sake, don't bet your country or your Presidency on the debt crisis resolving itself, especially if you don't have to. And on these issues we have been talking about today, you don't have to.

Senator, you asked us to identify for you the major solutions to this problem. There are five.

The first is, the policies of the developing countries themselves. They have got to get their house in order and keep it in order. But as Al Fishlow said, out of necessity they are doing far more than many people in this country give them credit for.

Second, average real U.S. growth and OECD growth for the next 5 years has to be at 3 percent or higher. We are not yet assured of doing that, but we can.

Third, the dollar has to come down and stay down and we have begun to tackle this one.

Fourth, protectionism has to be contained and so far we have done so reasonably well.

And fifth, there has to be an increase in credit flows or we won't make it the subject of tomorrow's hearing.

Now, on the issue of protectionism: How does one contain protectionism as a major cause of the low case scenario of not muddling through? There are four things that need to be done.

The first one we have already discussed, which is to get the budget deficit down, and thus get the dollar down and thus help U.S. exports and make imports more expensive. Getting the budget deficit down and expanding coodination between the major industrial nation's central banks can probably ease the high dollar part of the problem and we seem finally to be making some progress on that deficit.

The second one, Senator, is trade adjustment assistance. We must begin to say to American labor, as the Japanese say to their labor, work security is guaranteed you. If this nation is going to gain from expanded trade, we will not throw a few of you on the scrap heap of history by saying that that is just too bad and if you are dislocated because of rising imports we are not going to pay any attention to you.

Senator Bradley and others have now introduced an adjustment assistance bill, as you know. It is S. 1524. And Fred Bergsten and Gary Hufbauer of the Institute of International Economics have just testified in favor of that bill which is a new self-financing approach to trade adjustment assistance.

It seems to me if you want to combat protectionism, you first get the dollar down, you second offer serious retraining and work security to the people that are affected by import competition. If you have got both those things in place, then you launch a new Reagan Round of trade negotitations.

Mitterrand was right when he said there should be no new trade round unless we tackle the problem of exchange fluctuations and the high dollar. Everybody poo-poohed him at the time. We have now done that. We can now go forward with a new trade, Reagan Round, if we get the dollar down and it stay down, especially if we also have a new self-financing adjustment assistance program in place.

Finally, what we have been talking about all day in these hearings is the need for increased credit. Voluntary lending alone won't do it. But the order of magnitude that Treasury Secretary Baker is talking about, of getting the banks to do $20 billion more in the next 3 years and the multilateral lending agencies to do $9 or $10 billion more, a combination of about $30 billion over the next 3 years, would be a major step forward in reducing these risks to acceptable limits. Thank you, Senator.

[Mr. Jones' prepared statement follows:]

PREPARED STATEMENT OF PETER T. JONES

TRADE POLICY

I. President Reagan's Own Stake in the Growing Developing Nation Debt Crisis

Thus far, President Reagan and his administration have demonstrated considerable political courage and success in containing U.S. protectionism, especially in view of the rising power of protectionism worldwide. The real value of total world exports in the last two years has again begun to climb, having fallen some 25% between 1980 and 1983. In that sense, at least at the moment, we again have trade between the nations capable of continued growth, despite rising trade barriers and protectionism and diminished GATT effectiveness.

A favorable judgment of history, and with it one form of positive immortality, is a most important goal of any Presidency. So far during this President's regime, much has also been done to strengthen America's defense and economy and America's own self confidence. To date, therefore, if we could stop the clock at this point, net net, history would in all likelihood look kindly on Ronald Reagan and the first term of his administration.

So far so good. But the same would have been said, and in fact was said, about Presidents Hoover and Johnson. Both scored very well in the first parts of their time in office. And then they both blew it. Lack of ability to really understand massive sea change, and lack of will and capacity to change course to cope with such change—a .pa worldwide depression and the Vietman war—totally destroyed the net favorable balance sheet history would otherwise have drawn on both Presidents.

A similar risk now confronts President Reagan concerning his own role in history with regard to the great issues surrounding America's vital stake in the debt, development, and democracy of the third world. Because of the capacity of these issues for grave mischief with the international financial system, U.S. national security and U.S. international competitiveness, the road taken, or not taken, in dealing, or failing to deal, with these issues could well determine history's final net judgment of Ronald Reagan.

You, Senator Mathias have once again been ahead of your time and most of your colleagues at both ends of Pennsylvania Avenue in recognizing that this is so. I know, first hand, how long and tirelessly you have worked to reduce the risks of disaster and bring about mutually beneficial solutions to these problems. For this, our nation, our hemisphere, and the world at large owe you much gratitude for what you have done to help key people and the public understand that there is a clear and growing danger that this debt problem can get seriously out of hand.

Risks to the U.S. and World Financial System

Too dramatic? There is experienced conservative authority to the contrary. Paul McCracken, former Republican Chairman of the Council on Economic Advisers, is a fellow member of the Executive Committee of the bipartisan Bretton Woods Committee cochaired by former Treasury officials Joe Fowler and Charles Walker. In a lengthy meeting we had recently with Treasury Secretary Jim Baker, McCracken said:

> I am not an alarmist, but the recent decline in the availability of credit in important segments of the international economy in today's context is reminiscent of the situation that prevailed in the late 1920s. This makes it all the more important that we act in timely fashion to insure that adequate financial mechanisms are in place to prevent avoidable fears and disruptions from occurring."

Those views very much reflect the views also expressed by other distinguished members of the Bretton Woods Committee who attended the meeting with Secretary Baker. These same members are, of course, equally concerned over rising protectionism which could well threaten a return to Smoot Hawley high trade barrier days, especially if the dollar does not come down much further and stay down. Any simultaneous sharp contraction of both credit and trade would be doubly dangerous. The two phenomena, when growing simultaneously, can feed on each other with a serious multiplier effect downward.

Preston Martin of the Federal Reserve recently expressed his own growing concern over these risks to the international financial system. The timing and nature of his proposed remedies may have been validly in dispute.

But there is a growing consensus that voluntary credit flows from private banks over the next three years will not be adequate to do that essential part of the total job which only foreign credit can do to help prevent debtor developing nations from doing very serious damage to themselves and the international financial system.

Those risks are greater in the next three years than any which occurred in the last decade or more, including the initial debt crisis of 1982. The reason is weariness on both sides. The initial stage of any crisis mobilizes people to rise to great heights and outdo themselves. But with the passage of time in the trenches, great weariness sets in and risk of loss of hope, will and capacity to act boldly mounts. That is the time of maximum danger.

Political and National Security Risks

Henry Kissinger, Phil Habib, Riorden-Roett, and others have effectively highlighted the serious political and national security risks to these nations and the United States which their unresolved foreign debt problems presently entail. For example, the anarchy, violence and East-West conflicts we see today in Central America would pale in comparison to what we would confront if similar conflicts broke out in the Andean Region or elsewhere in Latin America.

Risks to U.S. Competitiveness

I would like to add one more factor that seems to have received little attention to date. It also requires us, in our own national interest, to be more forthcoming in our trade and related credit policies toward the debtor developing nations in difficulty, most of which are in Latin America.

There is a rising chorus of concern over growing hard-fact evidence of declining American competitiveness in the U.S. and global economies. This includes the continuing, and in some instances increasing, ability of Japan and other East Asian nations to outinvest, outgrow, outproduce, and outsell us at home and abroad. More and more observers believe that while a significant decline in the dollar would ease the situation, it will not solve it in the sense that as things now stand a number of these Asian-rim nations are likely to continue to outperform us.

For example, as long as Japan, with half our population, continues to save and invest more than we do and turns out better quality products than we do, and more engineers, including electronic engineers, in absolute numbers, than we do, and relatively more citizens competent in international business and other foreign languages than we do, we will still be in competitive difficulty even if the dollar comes down markedly.

Such ongoing competitive disadvantages, should they continue, as presently seems likely, indicate we will continue unduly to lose exports and export-market share in world markets. With our own foreign [illegible] continuing to climb to help finance both our own budget and our trade deficit, more and more exports will be needed to service that growing foreign debt.

Sooner or later, that means we could well run short of adequate export earnings and capacity to borrow still more abroad to pay for both the annual debt service on our mounting foreign debt and those imports critical to our own growth and welfare. Slower growth in exports, and under some circumstances in imports important to our own growth, in turn means the growth rate of the overall American economy slows down. The only alternative at that point would be to print dollars and lose the battle against inflation which also slows down real growth over time.

Thus, the continued decline of American competitiveness in world markets as we lose exports to other nations could have a very serious impact indeed here at home. In fact, our loss of exports to these key debtor nations in the past several years has already cost us over $18 billion in our trade balance and over 500,000 U.S. jobs. The analogies being drawn to Brazil and Mexico today are inexact, to be sure, but none the less instructional.

However, we do still have a number of competitive advantages over our Asian challengers in some parts of the world and especially in Latin America, where much of the debt problem is located. As a general rule, a larger portion of any increased availability of foreign exchange for imports in Latin America will be spent in the United States for U.S. goods and services than in any other country in the world. This is because there are many advantages which the U.S. has historically enjoyed in trading with Latin America, including geographic proximity, lower costs of transportation, know-how, experience, interrelationship through American investments, and subsidiaries located throughout Latin America. More of us have been living and working and traveling there and doing more business, banking, and government work there than all our Asian friends put together for well over a century. And more of us speak, write, and read Spanish well than do our Asian challengers.

In 1981, before the debt crisis took its toll, Latin America accounted for $42 billion or 46% of all our exports to the entire world. In 1984, with a decline in our total exports and disproportionate decline in our exports to Latin America because of the debt crisis, we still exported $27 billion to Latin America, which was 40% of our world total.[1] Thus whether or not in recession and restricted capacity to import, Latin America is impressively important to us in terms of export earnings, jobs, and growth, reflecting many competitive advantages we have *vis* the rest of the world. And we represent an important market for Latin American exports to the U.S., with 39% of our total world imports coming from Latin America.

So why are we treating that vital continent to the South like some poor cousin who doesn't count for very much in the global scheme of things except that it's having a difficult time servicing its loans from U.S. banks? Why aren't we more actively and effectively concerned with (1) our 11% average annual loss of exports to Latin America between 1981 and 1984 and related heavy job loss and (2) what to do about it?

And why aren't we more effectively concerned not only with this immediate loss of jobs and exports but still more importantly with the inherent and growing risks these unresolved and mounting debt problems represent to our medium and long-term competitiveness in global markets? We have been rendering useless our many historical competitive advantages *vis a vis* our Asian challengers with regard to exporting and investing in Latin America.

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[1] See excellent new study published by John Sewall's Overseas Development Council entitled *Hard Bargaining Ahead: U.S. Trade Policy and Developing Countries*, Ernest H. Preeg, ed., (New Brunswick, N.J.: Transaction Books, 1985).

This is because we have not yet adopted and helped finance a strategy to achieve sustained reasonable levels of real Latin *per capita* growth within the next two to three years. This is what the internal political timetables of many of these nations require to avoid destabilization at home and abroad.

We would not treat a similar situation in Western Europe so cavalierly nor leave it primarily to the private banks to handle. And we should not do so in Latin America where we have so many vital stakes in renewed per capita real growth throughout that continent.

But, say the Panglosses in Washington, all is right with the world, the invisible hand of the market place will do the job.

The Third Law of Latin Thermodynamics

This totally overlooks the Third Law of Latin Thermodynamics:

"*After three years of austerity, everything blows*".

There is empirical and historical evidence to support a rule of thumb that after three years of austerity, give or take, a Latin American austerity program blows or the government itself blows. If left to its own devices, a government either prints money to create jobs, which jeopardizes sustained noninflationary growth or political-military forces in the country overthrow it.

This is not to say that the principal reason that these nations abandon austerity programs after three years or so is necessarily because they simply lack the political will power to continue taking the austerity medicine that is really good for them. Sometimes that is true. But in other cases excessive money supply and demand have been squeezed out of an economy by the austerity program to a requisite or even excessive extent in the first three years and growth has slowed to a crawl. What is then called for is moderate expansion of demand, or at least no further contraction, and somehow obtaining incremental resources for productive investment and increased growth. Thus, when after three years or so an austerity program or its sponsoring government is blown out of the water, it may at times be for good and sufficient reasons rather than lack of stomach for doing what is right.

In any event, most agree that 90% of whatever task, policies and practices are required to do the job must be done at home. But this must be accompanied by adequate net additional foreign credit, export earnings and investment capital, to provide the necessary capacity to import for that level of per capita real growth essential to any margin of political and economic safety. Otherwise, the necessary discipline cannot be maintained, foreign debt obligations may well be disavowed and governments may fall.

With the notable and laudable long-time exception of Paul Volcker and new exceptions at State and Treasury, there are still too many key people in the U.S., some in the administration, some in the Congress, and some in the creditor banks, who have privately advocated and publically practiced "holding the Latin debtors' feet to the fire" and "keeping them on a tight short-term debt tether." They see this as the only way to extract sufficient sacrifice and discipline to get the Latins to pay their U.S. bank debts, set their house in order and, as their debts shrink in relative size, get their economies modestly moving again. The basic attitude and ideology is often privately cynical and at times even contemptuous of the Latins' ability to govern themselves or their economies in a responsible manner. Someone else must hold their feet to the fire with short-term debt only. That represents the necessary short tether required because you can't trust them to act responsibly on their own.

This view, which is still prevalent in some powerful circles in Washington and New York, is all too reminiscent in attitude and ideology of leading members of the British Conservative Party during the Irish potato famine.

In 1847 in Ireland millions became unemployed and deaths mounted as the potato crop failed again for the third successive year. But the archconservative British Government washed its hands of the whole affair. It threw responsibility for solving the problem entirely onto local Irish public and private resources, which simply lacked the resources to handle the matter alone. The man in charge, Sir Charles Trevelyan, went off with his family for a fortnight's holiday in France after writing:

> "It is my opinion that too much has been done for the people. Under such treatment the people have grown worse instead of better, and we must now try what their own independent exertion can do..." or you run the risk of paralyzing all private enterprize.

He echoed these same social Darwinian sentiments toward the starving victims of the Irish potato famine when he said:

> "The only way to prevent people from becoming habitually dependent on government is to bring (relief) operation to a close. The Uncertainty about the new crop only makes it more necessary... Whatever may be done hereafter, these things should be stopped

> now, or you run the risk of paralyzing all private enterprise and having the country on to you for an indefinite number of years."

And again when he wrote:

> "If [the jobless and starving persons] once find out there are any circumstances in which they can get free government grants...we shall have a system of mendicancy such as the world never say."

This is not the attitude of Paul Volcker, nor Jim Baker, nor George Shultz. But it is the attitude of enough powerful individuals at both ends of Pennsylvania Avenue to warrant serious attention. Otherwise, the new beginning initiatives by Secretary Baker could well result in too little too late being accomplishd in our own vital national self interest.

There is only one way to achieve sustained discipline and growth over time with anyone in Latin America or elsewhere for that matter. This is especially true when, as today, unemployment is at record heights and growing, not diminishing, and a growing number of people lack the basic necessities of food, clothing, and shelter to survive. It is why the Third Law of Latin Thermodynamics tells us austerity alone will not work after three years, especially in those cases where austerity alone has ceased to be the right medicine.

Internal sacrifice must now be accompanied by sufficient external resources from prudent but liberal trade and financial policies by the industrial nations toward these debtor nations. Only then will there be the essential resources, resolve, motivation, and expectation of success to sustain the painful, risky process of postponing some important present needs, not just wants, for future growth.

Since no individual and no majority will voluntarily postpone for long present needs for future greater gain unless each believes he or she will share in that future gain, it is also up to each nation to achieve that essential ingredient of broad-based sharing in any sound growth-oriented strategy. Otherwise, even with adequate external resources, the odds of sustaining a democratically based disciplined development strategy of growth are very low indeed.

Are We Not Muddling Through?

But, say the Panglosses of Washington, everything is for the best and, besides, are we not muddling through?

The answer is twofold:

1. The Third Law of Latin Thermodynamics also says:

   "After three years of austerity you will cease to muddle through".

2. To assume the current course will muddle through, also violates the First Law of Presidential Prudence: "Don't bet your country or your Presidency primarily on the invisible hand of the private sector operating under the discipline of the market place to muddle through for you, especially when:

   (a) their interests are much narrower and even different from yours;

   (b) their capacity to handle the problem is substantially less than the solution requires and much less than your full capacity combined with theirs; and

   (c) if they fail, your country for a spell and your Presidency for good will be in very serious difficulty.

This First Law of Presidential Prudence is akin to the First Law of Chief Executive Survival in Major Companies:

> "Don't bet your company on any trebble damage antitrust suit where you could be liable for industrywide damages which would wipe out your company. No matter how favorable the odds of winning, no matter how good the prospects of muddling through, don't bet your company. Settle!"

Chief Executives always insure against such huge disasters no matter how small the risk of one materializing, by paying something and settling to prevent the judge from ever getting the chance to decide the case against the company. The adverse consequences are so huge if you lose, you cannot afford to take even a reasonably small risk. And the record shows that CEOs don't.

Nor does anyone with a dependent family rationally refuse to have some kind of life insurance, no matter how young and healthy and low the odds of death. The strategy of prudence and least regret means you pay what it takes now to eliminate or further reduce the risk of true disaster later. And the greater the disaster, should it materialize, the further you should reduce the risk and the more be willing to pay up front to prevent losing all later.

In sum, you don't bet your family, your company, your country, or your Presidency if you don't have to.

There is now for the first time encouraging evidence that under the new leadership of Secretary of the Treasury, Jim Baker, forces within the administration are becoming aware of the true nature of this growing crisis and the need for an activist interventionist role by the U.S. government if it is to be contained.

Several of the most important remedies required to further reduce the risk to the country and the Reagan Presidency concerning America's stake in the debt crisis are sufficiently manageable and relatively low cost so that it would be truly foolhardy not to adopt them. Others are more difficult to accomplish, but even more important long term.

The required remedies all concern curing those harmful policies, practices and other major factors which would otherwise produce the unacceptably low growth case of debtor developing nations average annual real GNP growth of 2.5% or less during the period 1986 through 1990. Senator Mathias asked us to identify (1) the major policies and practices which would produce this 2.5% low growth case as well as (2) a high growth case of 5.5%, and (3) the likelihood of each case occurring, and (4) our recommended actions.

Principal Causes of the Low Growth Case

Four of the most important factors which would do most to bring about this low growth case, in my judgment, are:

1. The inability of the debtor developing nations, governments and private sectors in practice to do those things which are necessary to mobilize savings and attract equity and debt investment in productive activities. Without this, it will be impossible to achieve the sustained real growth levels adequate to slowly reduce unemployment, service existing

debt and thus attract additional credit and equity. Inability to achieve such a strategy would virtually guarantee the low growth case and probably worse.

2. OECD industrial nations average annual real GNP growth, 1986 through 1990, of less than 3%, with corresponding rising unemployment and falling demand for imports from the debtor developing nations, contributing significantly to a low or no growth case.
3. Rising effective protectionism in these OECD countries due to less than 3% real growth or in the case of the U.S. a continued high dollar exchange rate even with a 3% or better growth rate. Again, this would further curtail imports from developing nation debtors and thus help to produce the low growth case.
4. Falling or negative net credit flows from OECD public and private sectors to the developing nations. This would further curtail their ability to import needed capital goods, spare parts, etc., from OECD nations essential for renewed growth.

The Administration, through Treasury Secretary Baker, has begun to move on important parts of these key problems. Initial coordinated efforts to bring down the dollar and now to increase the role of the World Bank and the private banks are encouraging. Baker also insists on more effective .pa efforts by the debtor nations and the World Bank itself to tackle the underlying internal problems of these nations without which no long-term progress is possible.

Senator Mathias has also asked us to discuss major underlying policies and practices which directly impact trade policies which contribute the most to producing the low and high growth cases. He has also requested (1) comment on the likelihood of each combination occurring and (2) recommended actions.

I will discuss primarily some causes and cures of U.S. protectionism which in the trade field would do the most to produce the low growth case. The alleviation of protectionism would do the most in the trade arena to help produce the high growth case. I will also discuss related credit obstacles to increasing U.S. and OECD exports to the debtor developing nations and how to remedy such obstacles.

Protectionism, The Dollar and the Budget Deficit

Slow growth and a high dollar are two principal causes of protectionism in the U.S. Behind both is the budget deficit. President Reagan has not provided the requisite leadership to reduce that deficit and only he personally can do it. It is neither within the function nor capacity of the Congress to do this without firm clear top priority leadership from the White House. President Reagan must finally say first to himself and then to the American people,

> there is no, repeat no, economic or idealogical priority as important as to begin now to sharply reduce the budget deficit.

He will only do that after he has become convinced that

> there is no, repeat no, effective economic solution to sustained lower interest rates, and thus sustained lower dollar exchange rates, and thus lower protectionism except to begin now to substantially lower the budget deficit. To do otherwise, will, in all likelihood, lose the temporary benefits of the recent correct initial coordinated action by the five leading nations to lower the dollar's exchange rate. If the dollar goes back up and protectionism really gets out of control, this would seriously risk major damage to the country, and the multilateral trading system and the global economy for a long time and to the Reagan Presidency forever.

More evidence that the risk of this is real: Our own current slow rate of total growth, and negative growth in important sectors, is due in significant part to our huge and growing trade deficit. This is in large measure because of the high dollar which in turn is due to a great extent to high interest rates: all of which are primarily caused by our excessive budget deficit. As to the nature and degree of risk all this entails, President Reagan's own, just-retired budget director, David Stockman, recently said,

> "the unfolding situation is not a depression in the classic sense where the economy grinds to a halt..." but "I think it is close to a depression in selected senses".

He cited the farm, steel, textile, and other sectors as examples and reiterated the necessity for sizeable tax increases and spending cuts to reduce the budget deficit as the only lasting solution.

President Reagan must somehow be persuaded that cutting the budget deficit becomes like Vince Lombardi's view of winning at football. It's not only the most important thing, it's the only thing that counts until it is accomplished.

The risks of a continued high dollar and high interest rates and resulting huge trade deficits and a quantum jump in protectionism, all produced by continuing the same magnitudes of budget deficits, are much greater than the risks that cutting the deficit would cause a major prolonged recession. Therefore, substantially reducing budget deficit is now the number one economic priority.

This means reducing the budget deficit is more important than not raising taxes. The only way the President can cut the deficit substantially and begin to do so now is to settle for some tax increase along with further defense and social expenditure reductions. He must agree to some tax increase and realize that the proposed deficit reducing measure tied to the debt ceiling legislation must allow for this to succeed. He must understand that not to do this is recklessly and needlessly betting both his country and his Presidency.

Moreover, certain revenue increases, such as a significant surcharge on imported oil, which Professor David Teece of the School of Business Administration at the University of California at Berkeley, the New York Times, and many others have proposed, are politically supportable and distinguishable from across-the-board income tax increases. The imported oil surcharge also has so many other major net clear benefits for the American people, including a significant reduction in our trade and budget deficits, and enhanced conservation and efficiency in use of oil and national security benefits that a little political courage from the White House in such areas would go a very long way indeed. As Professor Teece will discuss at these hearings, any negative impact of a resulting lower price of oil on nations like Mexico can and must be offset. I would add that less dependency on oil for foreign exchange earnings might well even be a good thing for Mexico and other oil exporting nations in the long run by stimulating an accelerated increase in manufacturing exports.

The highest authorities dealing with our nation's monetary policy have also effectively answered the related question:

> "What if sharply cutting the budget deficit lowers interest rates and further strengthens world confidence in the U.S. economy as the safest haven for investment, won't that further push up the exchange value of the dollar and increase the U.S. trade deficit and protectionism?"

Their answer: once the budget deficit is substantially reduced, monetary policy then can help further bring down interest rates which in turn will help stimulate growth at home and abroad and help bring and keep down the dollar and protectionist forces in the U.S.

Protectionism and Trade Adjustment Assistance

The next essential priority for effectively combatting U.S. protectionism, short and long term, is a new and much more effective approach to trade adjustment assistance.

Why in my judgment does this rank higher than any other policy except budget deficit reduction and international coordination to bring and keep down the dollar? Because it is part of the most important strategy for reversing declining American competitiveness in the international economy, which is the best, if not only, long-term antidote to protectionism.

That strategy is to give those Americans adversely affected, or potentially adversely affected, by America's expanding trade with the rest of the world the reasonable assurance that they will not be assigned to the scrap heap of history and sacrificed for the good of the majority.

Until they have that assurance, they will quite understandably and in some senses justifiably use the nation's democratic and union machinery to periodically succeed in creating more protectionist trade barriers and more effective resistance to technological innovation necessary to improve our international competitiveness, but also entailing job dislocation.

We must adapt, not adopt, the Japanese extensive practice of assuring life-long work security, not job security, to its workers. This entails better training and retraining and more savings and investment and more productivity gains than we presently achieve. But the first step in such a program which would be most directly and politically effective in reducing the forces of protectionism would be a new more effective trade adjustment assistance program wholly self-financed through the mechanism of user "costs" charged to those who benefit from import flows.

I had the privilege of being one of the negotiators and drafters of the first trade adjustment assistance legislation. It was the AFL-CIO's principal condition for supporting President Kennedy's Trade Expansion Act of 1962, which Secretary of Commerce Luther Hodges asked me to manage for the Department. Presidents Kennedy, Johnson, Nixon, Ford, and Carter all supported it. And, while overly restrictive in its criteria, funding, and administration for much of its history, its existence clearly helped maintain support for trade expansion and liberalization and less protectionism than otherwise would have been the case for over twenty years.

The Reagan Administration badly gutted the program in the first term for ideological and budget cutting reasons, but recently asked for an adjustment assistance program to be designed for the shoe industry as the alternative to granting it protection.

Fred Bergsten, Director of the Institute of International Economics and Georgetown Professor Gary Hufbauer recently presented most persuasive testimony to the Congress in favor of S.1544, sponsored by Senator Bill Bradley and others to create a new, wholly-user cost financed, trade adjustment assistance program.

While the Bergsten-Hufbauer proposals differ in some respects from S.1544, they stand together on the following important principals:

1. both would generate *new* revenue from trade flows themselves by converting more onerous quantitative restrictions into revenue producing requirements;
2. both would use these new revenues to self-finance trade adjustment assistance with an expectd modest surplus available for budget deficit reduction;
3. both would use the new revenues for more effective and earlier retraining tied more closely to new job opportunities and making various approaches available, including voucher systems for retraining;
4. both would endeavor to accomplish this through international negotiations to honor our GATT commitments and focus attention on new innovative approaches to encourage the importance and success of the proposed new multilateral round of trade negotiations.

I would add my own strong endorsement of S.1544 and the Bergsten-Hufbauer testimony as one high priority element in combatting protectionism. Not to do this would play into the hands of protectionists, weaken our international competitiveness, and have a disastrous impact on the ability of debtor developing nations to grow and service their international debt.

Protectionism and the New Multilateral Round of Trade Negotiation

If the new coordinated five nation attack on bringing down the dollar can be combined with successful Presidential leadership to sharply cut the budget deficit and achieve passage of the new trade adjustment assistance legislation, then there is a solid foundation for obtaining the necessary legislation from Congress to authorize a new major multilateral round of trade negotiations. With these measures accomplished, a new round of trade negotiations would produce genuine benefits for the United States and all its trading partners.

Mitterrand was right, although everyone pooh-poohed him at the time, when he said a new trade round would fail without simultaneously addressing a coordinated attack on exchange rates and especially the dollar. But the latter has now at least begun. And President Reagan has called for an adjustment assistance program for the shoe industry. And he is now making new noises about eliminating the budget deficit by 1991. And Secretary Baker has taken the first steps to create an activist role for the administration and the World Bank in encouraging the private banks and debtor nations to make their essential contributions to resolving the debt crisis.

With these first steps taken, it would seem that moving forward on the new Reagan Round of multilateral trade negotiations is the right thing to do. The risks of failure are, of course, ever present. But the bicycle theory is correct. It's either momentum forward or over you go in a ditch of more protectionism and trade contraction.

What is now needed most on each of these fronts is to prevent the real danger of too little too late. Boldness and determination are now required. Lip service or psychological media gestures without real resources behind them won't do it. These initial moves are in the right direction and should be applauded and supported. But they also should be watched very carefully to make sure they continue to strengthen until the job is done.

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Protectionism and Capital Flows to the Debtor Nations

One of the greatest risks of too little too late concerns the lack of sufficient foreign exchange to restore reasonable rates of growth and meet debt-service obligations. The most optimistic estimates of export earnings, foreign direct investment and reversed capital flight, and voluntary private bank lending fall at least $20 billion short from private banks alone over the next three years according to the Administration's own estimates of what is required, and that may well be too low. Minimally adequate rates of real per capita growth can not be achieved without at least this $20 billion more in private bank credit flows in the next three years. This will require increased IMF and World Bank, and perhaps OECD governments' direct involvement, in some cases with cofinancing, increased guarantees, and greater long-term public lending. $20 billion from the private banks over three years would represent about a 2.5% annual increase in net lending over current outstanding loans. Another $9 or $10 billion will be needed from international development banks over the same time period, again according to Administration estimates which may be conservative.

All of this is necessary to ease the debt crisis and increase debtor-nation growth, and to increase exports from the U.S. and other OECD nations of goods and services essential to achieving that renewed debtor-nation growth.

William Bolin, retired Vice Chairman of the Bank of America and authority on Latin America and the debt crisis, in his written statement to these hearings highlights the special importance of increasing trade credits to facilitate the debtor nation's ability to import more from the industrial nations. This is essential to increase overall growth rates of these debtor nations. It also directly benefits the U.S. and other participating OECD economies. The $300 million fund proposed by the Administration to compete with mixed export credits offered by other industrial nations is a start to strengthening U.S. competitive capabilities but too small to make a major difference to U.S.

It would be hoped that Japan, with its surplus domestic savings and trade balances, would also realize its own national self-interest in providing more debt and equity capital to these key debtor nations in Latin America and Asia on more favorable terms. As a world citizen, Japan can do much to make sure the growing interdependency of all nations is enhanced by balanced sharing of its surplus resources for the good of all concerned.

Conclusion

The U.S. has enormous stakes--financial, political, security and economic--in resolving the growing debt crisis of many developing nations in many parts of the world, but especially in Latin America. Recent first steps by Secretary Baker and the President to move toward tackling the underlying causes of these problems are encouraging.

Too little too late across the board is still the principal danger. Powerful forces in parts of Washington, parts of the banks, and parts of the debtor nations still oppose doing more than what would be too little too late.

By nature an optimist, I would have to say the prospects have brightened for new approaches to renewed growth taking hold. If there is substantial follow-through, this would enable all of us together to muddle through. But all of us together must keep the heat on and demonstrate to the decisionmakers that these first small steps will count for naught unless followed by substantial new commitments of net additional dollar resources beyond what would voluntarily flow. All can still be lost if this is not done. $20 billion over the next three years in net new private bank credit flows may well not be enough. It is certainly the minimum that is needed from the banks given the current overall outlook, and will have to be supplemented with World Bank and other increased public lending of $9 to $10 billion during the same three-year period.

It is in our own high national interest to do at least this, and if possible, somewhat more. If we can do our share to restore reasonable growth reasonably soon, it will do much to prevent the debt crisis from getting out of control. It will also enhance our own growth and international competitiveness as well as our financial, political and national security interests, which are so linked with these debtor nations. It will also be another step toward achieving what Toynbee tells us is now possible:

> For the first time since the dawn of history that all men everywhere can enjoy the benefits of civilization.

Thank you.

Senator MATHIAS. Thank you, Mr. Jones.
Professor Tyson?

STATEMENT OF LAURA D'ANDREA TYSON, ASSOCIATE PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA AT BERKELEY

Ms. TYSON. I would like to address my comments in three different directions. First of all, I would like to try to emphasize the relationship between the developed and developing countries in terms of how the conditions in developed countries have influenced both the evolution of the debt crisis in the developing countries and their ability to handle it.

Second, I am going to try to emphasize the relationship between trade flows and capital flows, that is, when capital flows between the developed and developing countries change, what are the implications of those changes for trade flows.

Finally, I want to talk a bit about the conditions that I think need to be satisfied by the developed countries as necessary but not sufficient to solve the debt crisis in a growth-promoting manner.

It seems to me that the relationships between the developed and developing countries come out very clearly if you look at the situation in 1983 versus the situation in 1984.

In 1983, the debt crisis developments were largely influenced by the recessionary conditions in the developed countries and by the interest rate conditions and capital availability conditions which were set by changes in the capital markets in developed countries, leaving the developing countries faced with higher than anticipated interest payments with much reduced, relative to expectations, capital inflows and much depressed export markets.

The only real choices for the developing countries under those conditions, environmental conditions shaped by changes in the developed countries markets—both capital and trade—the only choice for the developing countries in the short run was a major cutback in imports.

The major cutback in imports did indeed occur. If you look at the major debtor countries in Latin America in 1983, imports fell by 40 percent. There was really nothing in the short run that the debtor countries could do except to cut back their imports.

The way to interpret what happened is essentially that once capital market conditions facing the developing countries changed, once capital outflow became a necessity, the only thing the developing countries could do was to change their trade account. And the only thing they could do in the short run was to cut their imports.

Now I want to emphasize in my comments the implications of this for U.S. economy. Since much of the import cutback occurred in Latin America, there was a major influence on the U.S. economy. In fact, in 1983 there was a 48-percent decline in the imports of U.S. manufactured goods to Latin America.

Peter Jones has indicated, Latin America is essentially the main area of the world where the United States does have a major competitive advantage against the other industrial countries and against competitor countries in East Asia.

So essentially, because of the debt crisis situation in 1983 in Latin America, the United States lost a very important market.

Now, in 1984, the year in which there was some optimism about the market solving the debt crisis, if you look at what actually happened, mainly what happened was an unsustainably high rate of expansion in the U.S. economy, an unsustainably high rate of imports into the U.S. economy—essentially, the U.S. economy went on an import buying binge.

And the binge was financed by capital inflows into the United States. So you had a situation in which capital was reversed and moving out of the developing countries and into the United States. The United States was turning around and using that capital inflow to import from the rest of the world and was in that sense supplying the revenues to the Latin American countries to help pay off their debt.

The implication for the U.S. trade account was of course a negative one. If you look at the increase in the export revenues, say, of the Latin American countries between 1983 and mid-1984, most of that—85-90 percent of that—went into the United States.

In fact, for the period 1981 to 1983-84, almost 50 percent of the exports of the major debtor countries went into the United States. Essentially we were buying up the goods which gave the developing countries the capital to help finance the capital outflow.

The consequence—even last year, a conservative estimate out of the Council of Economic Adviser's Report was that at least a quarter of the 1984 deterioration in the U.S. trade account was due to the decline in our exports to Latin America and the increase in our imports from Latin America.

Now, 1984 was unsustainable. It was unsustainable for the United States. And it was therefore unsustainable for debtor countries. That is, to the extent that their good performance in 1984 depended upon export revenues to the United States and to the extent that the United States could not support that rate of growth because of imbalances at home, the crisis which looked like it was solved in 1984 resurfaced in 1985 when the U.S. economy slowed down.

Even in 1984 there were signs that the crisis was not in fact solved, because even in 1984 with this major growth in export revenues to the United States, the major debtor countries of Latin America, for example, had very low investment rates, very low import rates.

They had enough growth in their export rates to meet their rescheduled payments, not their full payments, and to finance an increase in reserves. but certainly not enough to restore investment levels and import levels to the rates that would be required for medium-term growth at what we assume to be a target of maybe 5.5 percent to give them a per capita growth rate of 3 percent.

And so, even in 1984 when some people were saying that the situation was resolved, it was clear to those who were observing what was going on in these countries that it was not enough.

That brings us to what has happened in 1985. As the U.S. economy has slowed down as it has been unable to be the engine of growth for the OECD and therefore for the debtor countries. The imbalances which the whole system has generated of course have led to pressure for protectionism in the United States.

The change in world capital market flows and the consequent change in trade flows with major impact on the United States built up tremendous pressure for protectionism in the United States.

Many of these protectionist measures, as with past protectionist measures, have their major focus on the debtor countries, on Korea, on Brazil, on Mexico, on countries which cannot—if we really continue to pass protectionist legislation as we have in the past—manage to continue to service their debt.

We have the development of protectionism, and we have the slowdown at the same time of the export revenues of the developing debtor countries.

So that leaves me with what I think one learns from comparing 1983 and 1984 in terms of future policy. The first thing seems to be that all the scenario analysis suggests that to get out of the debt crisis in a growth-promoting manner, that is, to get out of the debt crisis in a way which will allow the major debtor countries to grow at something like 3 percent per capita a year, we need growth in the OECD of anywhere between 3.5 percent and 4.7 percent.

Now, these growth rates for the OECD are high compared to what happened between 1974 and 1984. And the only reason we even approached them last year was because the United States was growing itself into a major macroeconomic problem.

So, essentially, we have to worry about coordination among the OECD countries. We have to worry about getting the OECD countries to agree to a set of policies which stimulates not just the United States in an unbalanced way, but which puts more of the burden on the Europeans and the Japanese. And policy initiatives in that direction are certainly to be applauded.

Second, we need to continue to worry about interest rates. In my statement, I talk about the importance of declining interest rates. We have to worry about continuing the switch in policy mix in the OECD countries away from tight monetary policy and loose fiscal policy to tighter fiscal policy and looser monetary policy to keep the real interest rate down.

I think we have to struggle against protectionist measures, particularly those that target the debtor countries. I don't think that the U.S. trade deficit problem is to be handled by protectionist measures aimed at those countries.

I think the U.S. trade deficit problem should be handled by an exchange rate policy to correct the value of the dollar, by faster growth in European and other OECD partner countries, and by our own domestic policies that influence about what we are doing to our own competitive advantage in sectors in which we have a comparative advantage, such as computers and high technology equipment.

And finally, I think that if we manage to do all that, which I am afraid I somewhat doubt, if we manage to do all that, there still is a need for additional capital inflow.

Again using the World Bank figures, the estimates are that we need something like 3.8 percent growth in real net financial inflows into the developing countries between 1985 and 1990 just to generate on 3.0 percent per capita income growth.

Now, 3.8 percent net financial inflow is low by the standards of 1970 to 1980. But net financial inflow has been negative—that is, money has been coming out of the developing countries between 1980 and 1984. There is no evidence of a voluntary change on the side of the private credit markets, indicating that we really do need policy initiatives, I feel, particularly directed at the World Bank.

The IMF, it seems to me, has placed a pivotal role in stabilization and in mobilizing in short-term funds for short-term austerity measures. But what we need if we are going to get out of the debt crisis in a growth-promoting way are medium-term funds with medium-term conditionality.

I think the World Bank is the organization to carry out this that kind of adjustment.

Thank you.

[Ms. Tyson's prepared statement follows:]

PREPARED STATEMENT OF LAURA D'ANDREA TYSON

My name is Laura D'Andrea Tyson. I am an associate professor of economics at the University of California at Berkeley, and I am also a participant in the Berkeley Roundtable on the International Economy, an interdisciplinary research group that focuses on issues of international trade and finance and their implications for U.S. economic performance. I have also frequently served as an outside consultant to the International Bank for Reconstruction and Development.

Between this year and last year there has been an about-face in public perceptions about the severity of the debt problem of the developing countries and the implications for the developed countries, including the United States. Last year the debt crisis was widely hailed as over. The impressive growth in the exports of many of the major debtor countries, a reduction in their trade deficits, a slight recovery in their growth rates, and the progress of rescheduling agreements between debtor countries and creditor banks under the aegis of the International Monetary Fund were interpreted as evidence that the crisis was over and that continued progress in the resolution of the debt problem through the end of the decade did not require any new policy initiatives.

This year concern over the debt crisis had heated up, given fuel by faltering exports in several key debtor countries, continued debt-servicing difficulties despite massive reschedulings as in Mexico, and growing signs of popular dissatisfaction with slow growth in many debtor countries. Concern has also been heightened by the recent string of statements of the leaders of several debtor countries questioning the wisdom and sustainability of the policies they have been forced to pursue to meet even scaled-down repayment commitments -- and carrying the implicit threat that they will refuse to maintain such policies in the future.

An explanation of the about-face in views over the existence and severity of the debt crisis reveals the critical importance of both trade and capital market conditions in the developed countries, especialy the United States, to economic prospects in the developing countries. It also demonstrates how capital flows and trade flows between developed and developing countries are inextricably interrelated and how interdependence among these two groups of countries has grown in recent years.

During the 1981-83 period, a change in international capital market conditions led to a sharp reduction in the availability of new capital inflows to the developing countries. A critical factor behind these new conditions was the simultaneous imposition of strict monetary and credit conditions in the developed countries that drove up interest rates and restricted credit availability. The developing countries that had chosen to accumulate variable-interest-rate debt to finance imports and growth during the 1974-81 period found themselves strapped by higher than anticipated interest payments and by lower than anticipated inflows of new money. When new inflows of money proved insufficient to cover interest payments on outstanding debt, many debtor countries were confronted with the need to finance a net financial transfer to their creditors.

A change in the capital market situations confronting the debtor countries -- from one of net financial inflow to one of net financial outflow -- necessitated a change in their trade balances. To realize the financial transfer required by the capital market, the trade account had to be improved

-- either by reducing imports or by increasing exports or by a combination of both. Foreign exchange earnings from exports or foreign exchange savings from imports had to become a substitute for borrowing.

In the short-run crisis situation of 1983, import cutbacks were the major method for adjusting the trade account to reduced financing capabilities. For example, in 1983, Latin American imports declined by an average of 45% in nominal terms.[1] Such cutbacks were realized by a variety of administrative policies that raised protective barriers in these countries even higher than they had been before the debt crisis. Since many of the imports of the debtor countries had been tied to investment spending for modernization and technological upgrading, the cutbacks in imports were also associated with major cutbacks in investment spending. For example, in Brazil and Mexico, the 1983 investment rate was more than 25% lower than the 1976-80 average. In the short run, the debtor countries bought a rapid improvement in their trade deficits at the expense of future growth potential, but given the extent of the improvement required by changing capital market conditions and the recessionary conditions in the industrial economies that limited their export prospects, they had little choice.

The cutbacks in imports by the debtor countries had important trade implications for the industrial countries, especially for the United States which is the single biggest developed country exporter to the Latin American economies. An illustration, between 1981 and 1983, there was a 48% decline in United States exports of manufactured goods to the five major Latin American debtor countries. In 1984, despite a small recovery in imports by the eight largest debtors in Latin America, their imports were almost 45% below pre-crisis levels, and the major burden of this cutback fell on U.S. exports. As a result of the debt crisis, itself in part attributable to higher interest rates in the U.S., the Latin American market for U.S. products, the major market in which the U.S. retains a competitive advantage against other industrial exporters, fell into another great depression from which it is yet to recover.

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[1] The figures cited in this discussion are taken from either the 1985 World Development Report of the World Bank or Morgan Guaranty Trust, World Financial Markets, October/November 1984 and May 1985.

In 1984, many of the debtor countries achieved dramatic increases in their exports to the developed countries. The results were especially dramatic in Brazil and Mexico, the largest debtor countries. Their export earnings were sufficient to allow them to meet their 1984 debt repayment obligations, which had been scaled down by rescheduling agreements, and to finance small increases in imports, a resumption of economic growth and a buildup of reserves. Large export increases also allowed other big debtor countries, such as Korea, which had not been forced to reschedule debt, to continue to meet their repayment obligations without a sharp contraction in imports and growth.

The improved performance of the debtor countries in 1984 depended on two changes in the conditions of the developed economies -- a decline in interest rates that reduced the interest burden of outstanding debt, and even more important an acceleration of growth in developed country markets that stimulated demand for imports from the developing countries. This expansion of demand was a necessary condition for the export successes of the debtor countries, although the extent to which individual debtor countries benefitted depended on their own policy choices and supply situations.

Underlying the expansion in demand in the developed countries was the dramatic growth of the U.S. economy and a dramatic increase in its import elasticity. Fueled by large and growing capital inflows, an expansionary fiscal policy and an easing monetary policy, the U.S. economy went on an import buying spree. In 1984 about 45% of the exports of the debtor countries were sold to the United States. Between the onset of the debt crisis in 1981-82 and mid-1984, 85% of the increases in the exports of the Latin Ameican debtor countries went to the U.S. market. According to the 1985 Report of the Council of Economic Advisors, the sharp contraction in Latin American purchases of U.S. exports and the sharp increase in Latin American sales to the U.S. taken together accounted for almost 25% of the deterioration in the U.S. trade deficit in 1984.

As these figures suggest, the U.S. economy in 1984 became a kind of buyer of last resort. Funds flowed out of the debtor countries into the U.S. economy; these funds helped finance U.S. imports from these countries which in turn allowed them to meet their repayment obligations. Export revenues earned in the U.S. became a partial substitute for foreign capital in the debtor countries, foreign capital that had itself been redirected to the U.S. by the lure of higher interest rates.

When the U.S. economy began to slow down to a more sustainable growth rate in 1985, signs of the severity of the debt crisis began to re-emerge. Even in 1984, these signs were visible to those who chose to notice them. Despite increases in export revenues, in many debtor countries, including Brazil and Mexico, import levels and investment rates remained sharply depressed, per capita income levels were below levels attained in 1980 or earlier, and credit to rollover existing debt or to provide new financing was

not available on a voluntary basis from the private capital market. These signs indicate that even if the import binge of the U.S. economy had continued for several years, many debtor countries had no hope of meeting their repayment obligations while simultaneously achieving rates of growth necessary to restore per capita income levels. As long as credit flows did not expand, imports and investment would remain depressed, thereby undermining the possibility for restructuring, export promotion, and growth over the medium run.

In the event, the 1984 situation was not sustainable, because it was built on growing imbalances in the U.S. economy. As the value of the dollar continued to climb and the U.S. trade deficit continued to increase, the pace of the U.S. economy began to slow. Concern over the effects of the high dollar and imports on the competitiveness of U.S. industry began to mount and by mid-1985 led to tremendous political pressure for some type of protectionist relief. Not surprisingly, many of the protectionist legislative measures were aimed at the imports of the major debtor countries, especially Brazil, Mexico and Korea, which were already the victims of existing protectionist policies not only in the U.S. but in the other industrial countries as well. The passage of such measures would seriously erode the ability of the debtor countries to continue to meet their repayment obligations. This is true even for Korea, the country that to date has been hailed as the exemplary debtor country by the private capital market and the World Bank and International Monetary Fund.

Where then does this analysis lead in terms of policy recommendations? Several conclusions emerge from the discussion.

1. Maintenance of rapid growth in the industrial countries is a necessary but not sufficient condition for the resolution of the debt crisis. Moreover, to be sustainable, rapid growth must become more balanced among these countries -- in other words, there must be a coordinated effort among them to accelerate growth in Europe and Japan. The U.S. cannot continue to be the engine for growth because of the trade and spending imbalances that result. Existing scenarios suggest that an average OECD growth rate of 3.5% - 4.7% may be required, and this is high by the standards of the 1974-84 period.

2. The realignment of the macroeconomic policy mix in the industrial countries to ease monetary policy and tighten fiscal policy should be continued to keep interest rates down. This will hold down the interest burden on outstanding debt.

3. Protectionist measures that limit imports from the debtor countries must be avoided. The only way that these countries can earn revenues to bring down their debt over time is to export to the developed countries. Protectionism will slow the process or make it impossible. As far as the U.S. is concerned, an improvement in the trade deficit can be expected from more balanced growth among OECD countries, a lower value for the dollar, and a set of growth-promoting policies at home that focus on restoring competitiveness in sectors in which the U.S. has a comparative advantage. The failures of U.S. policy, not competition from the developing countries, are the cause of growing deficits in these sectors.

4. Finally, even if all of these conditions are realized, the experience of 1984 indicates that additional capital on improved terms must be made

available to many of the biggest debtor countries if they are to achieve per capita growth rates of around 3% over the medium term. For example, the most recent World Development Report of the World Bank lays out a high-growth scenario in which developing countries grow at 5.5% a year and industrial countries grow at 4.3% a year during the 1985-90 period. This scenario assumes that total net financial flows to the developing countries grow at 3.8% per year in real terms during the same period. This growth rate is low compared to the actual 1970-80 growth rate of 9.1% but it implies a sharp reversal of the nearly 10% decline in such flows that occurred between 1980 and 1984. At this point in time, there is no evidence to support the notion that private credit markets will generate the needed flow of resources on a voluntary basis. Particularly for the poorest countries and the biggest debtor countries, policy initiatives will be required. For such countries, additional lending by the World Bank for medium-term structural adjustment programs to improve export performance will be critically important. Policies to increase the funds available to the World Bank and to allow it to develop co-financing and guarantee programs for private debt and equity finance are needed. The International Monetary Fund has played a pivotal role in mobilizing short-term finance for stabilization programs in the debtor countries. But growing out of austerity and stabilization into restructuring and restoration of living standards requires medium-term finance with conditionality appropriate to medium-term objectives. The World Bank is uniquely suited to help the debtor countries realize these objectives and to resolve the debt crisis in a growth-promoting and lasting manner.

Senator **Mathias**. Thank you very much.

Let me turn to your first recommendation, which is that the maintenance of rapid growth as a necessary condition for resolution of the debt crisis.

But you say that to be sustainable, growth has to be balanced among various countries of the world, and that an average OECD growth rate of 3.5 to 4.7 percent may be required.

That is far above what is currently being experienced, although some of the European countries have broken the 3 percent limit. Some of them are far below 3 percent, some of them even have negative growth rates.

Ms. **Tyson**. Yes.

Senator **Mathias**. So there would have to be a rapid turnaround of the European picture to even come close to your description. Unemployment—even in the countries that are showing a good growth rate, unemployment is still a major, major problem.

Rimmer De Vries, the economist at the Morgan Guaranty, has suggested that if Latin American is to sustain its debt burden—not repay them but just to service them—there has to be at least what you are talking about in terms of economic growth in Europe.

In other words, Europe has to be able to grow and buy from South America in order to give South America the roll-over that they need in order to pay the interest on their debt.

What do you think the prospects are, with unemployment as high as it is in Europe, with capital relatively scarce, with the United States siphoning off a fair amount of European capital in our effort to pay our own debt service—what do you think the prospects are for achieving that kind of rate of growth?

Ms. **Tyson**. Well, as I said after I mentioned my first three conditions, I wasn't that optimistic that even the three of them would be met.

Let me say that I think that to a certain extent between my fourth condition, that is, capital inflow to the developing debtor countries, and my first condition, there are some tradeoffs.

That is, to the extent that we don't meet the growth target that would sustain this target of 3 percent per capital income growth in the LDC's, we can in a sense ease their debt situation anyway by greater inflows of capital.

But on the issue of the OECD, first of all, the unemployment situation in Western Europe is indeed partly a reflection of the fact that these countries have chosen for a fairly long period of time now to run policies which have been fairly restrictive from a growth point of view.

And the major explanation of that, it seems to me, is to look at the late-1970's as a decision around the world among the industrial countries to fight inflation.

So you get a series of restrictive policies—the only country that reversed itself in terms of overall restrictive policies was the United States. And we reversed ourselves in 1983. And the consequence was that we grew very rapidly in 1984.

Other countries have room to go in terms of stimulating their own economies, generating less unemployment, and solving some of their employment problems by stimulating demand.

They should be able to both satisfy domestic policy priorities and help the LDC's at the same time. That is, there is room for this growth both to improve economic performance, say in West Germany, and also to allow it to act as a source of greater demand for the developing countries.

There is room in Japan for the same thing. There is room for greater growth to generate additional demand to absorb greater imports from the developing countries.

I don't know whether or not politically that will be a choice.

Senator **Mathias**. We have talked about the complexity of this problem. Let me throw you one that deals with the complexity of it. Because as you know representatives of the NATO countries are now gathering in San Francisco for the North Atlantic Assembly which will reconvene tomorrow.

The NATO countries are not identical with the OECD countries. But there is a large overlap. They are committed to a 3 percent real growth in defense expenditures. And yet, some of them, as we have just commented, have negative growth rates in terms of their economy.

Now, should we as a leader of the NATO organization press for that 3 percent real growth? Or does that have a negative impact on the economy, on the chance of achieving that growth?

Ms. **Tyson**. Well, at the risk of being dubbed a two-handed economist, let me say the following.

I think from the point of view of stimulating economic growth in the OECD, an acceleration of defense spending in the short run is not bad. It certainly is one of the reasons that the U.S. economy has grown very rapidly.

All protestations about supply-side economics to the contrary, we have undergone a great Keynesian boom in this economy in the past couple of years that has been fueled by defense spending in large part.

Now, I think that the European economies could also speed up if they were to speed up their rate of defense spending. There is a real issue about the long-run consequences of this strategy for competitiveness and growth prospects, because, to the extent that you shift the allocation of resources away from private investment and towards defense spending, discounting any sort of spillover effects in the private economy, you may slowdown your rate of growth in the longer run.

But as a short-run measure to improve the rate of growth in the OECD, this strategy is something that would not be inconsistent with that NATO suggestion.

Senator **Mathias**. Turning to a specific trade problem, the United States in the last few years has withdrawn from the assistance to our own exports by reducing the activities of the Export-Import Bank, and by withdrawing other assistance programs which some critics would say subsidize exports.

Should we be more aggressive in offering competitive financing terms to support and encourage United States exports?

Ms. **Tyson**. I think the answer to that question is yes. In our competition vis-a-vis our industrial competitors in the Third World or in industrial country markets other than our own, I think that our share—our market share—has declined, there has been a long-term decline in market share, not just in products where we might expect a decline, like textiles or shoes, but also in products like telecommunications equipment and computers where we might not expect a decline, and we have accelerated that decline dramatically by not doing anything about the value of the dollar.

And then, furthermore, by undoing our export subsidies at precisely the moment we allowed the value of the dollar to appreciate.

That is, the fact that the dollar appreciated as an even stronger reason for the temporary use of export subsidies. But we undid them at precisely the moment we needed them the most.

Senator **MATHIAS**. Well, of course, there have been a number of us in the Congress who have tried to keep up the level of support for the Export-Import Bank. Unsuccessfully, I might add. Because it has been cut back.

And I think that probably has had an adverse effect on some exports. Now, the President, in his recent initiative in this area—which I welcome—does not propose to increase the activities of the Export-Import Bank, but to set up a $300 million fund for support of exports.

Aside from the fact that that is a rather modest sum, one nuclear energy plant sold by the United States—and that is a very competitive form of commerce. There is a sale, to be specific, a sale pending with Egypt that could consume the whole $300 million in one gulp if it were applied that way.

I am not suggesting that that is the way it will go. But just to give some sense of the proportion of the problem. Is that a good idea? Should we put this money in a separate fund? Or should we beef up the Exim?

Ms. **TYSON**. Well, actually, I don't know the reasoning behind a special fund versus the Eximbank. It seems to me that putting it in a special fund is like offering a temporary discount policy, rather than committing oneself to a longer-run price reduction policy.

It seems to me that the problem of U.S. competitiveness around the world is a problem which predates the debt crisis, it predates the appreciation in the value of the dollar. If you look at the period 1964–80 before the value of the dollar increased, there was already a long-term problem.

It seems to me we need a long-term solution. And one of the components of the solution seems to be greater funding for the Export-Import Bank, not less. So I would be inclined to put it into the Export-Import Bank on the grounds that we commit ourselves to some permanent attention to the issue of competitiveness.

Senator **MATHIAS**. Of course, that may be the very reason the President didn't put it in there.

Ms. **TYSON**. I think that is probably it.

Senator **MATHIAS**. Because he did not want to see it institutionalized and become permanent.

Ms. **TYSON**. I think that is how it is. In a sense, it is like offering a temporary discount you can take away if you don't need it.

Senator **MATHIAS**. Peter.

Mr. **JONES**. Senator, on your question earlier of protectionism in the debtor developing nations themselves and how do we square that with helping them. More U.S. export credit of this sort and more credit in general to these countries may be the best single bargaining tool we have to persuade them to be less protectionist in their own trade policies.

It is not that they need a lowering of trade barriers in our country so much in the trade negotiations, they most need credit and finance. And the one lever we may have in terms of reducing protectionism in some of these countries themselves, our best single lever may be the kind of trade credit availability at Exim that you are talking about.

Senator MATHIAS. Of course, I am not saying that that is not without some vices. But Exim, as I recall it, has operated on a profitable basis. It is not an enormous tax consumer. Exim operations have generally not only broken even but done a little better than breakeven.

Mr. JONES. Bill Draper has done a very good job as head of the Export-Import Bank.

Senator MATHIAS. One other question that does arise, and that is, could we be more discriminating among our trading partners in order to avoid weakening developing world debtors?

Mr. JONES. If you have to—eventually, have to go the route of some measures which would balance the trade playing field between countries, everyone I have worked with on this issue says you should design some mechanisms that are both temporary and focused where the problem really is, rather than having across-the-board rise in trade barriers. That that would be much preferable.

And if some of those more focused efforts could be negotiated so that they were mutually agreed upon, say by the United States and Japan, that would be even more preferable.

Senator MATHIAS. Of course, that requires a high degree of sophistication. Your observation is supported by the reports of Members of the Senate who went to the Far East with Senator Dole during this past summer.

They were impressed by the fact that countries with which we had a trade deficit had very different problems from each other. The only thing they may have had in common was that they were generating, from their point of view, a trade surplus with the United States.

But the reasons might be very different. And that if you try to apply one comprehensive solution to that specific problem, you would create other problems. Because what would operate in one case would not operate in another case.

But that, as I say, requires a high degree of sophistication and a lot of patience. And I am not sure that that isn't one of the weaknesses of our whole system, that we are not really set up to do that kind of country-by-country operation.

Mr. JONES. The one place where I think that kind of attention on both sides of the ocean is being given to the problem is between the United States and Japan.

My sense is that if our Japanese friends were willing and able to do something more to open up their markets in a hurry, then some of the tremendous protectionist sentiment in the Congress itself would be satisfied. Then you wouldn't have to do it across the board.

Ms. TYSON. When I think about that, I think about the premise—the whole discussion is premised on the view that somehow or other trade deficit problems should be handled on a country-bilateral basis.

And one of the underlying points of my argument is that to understand the U.S. trade deficit, I don't think it is appropriate to look at what is happening to the U.S. deficit with Korea versus the U.S. deficit with Japan.

I think one has to think about what is going on in the entire system. In the entire system there has been a tremendous change in capital flows. The only balancing act really has been for the U.S. trade deficit to take the brunt. I mean, essentially capital flows came into the United States and the trade deficit adjusted because that is where the capital flows were going.

It seems to me to approach the problem in the wrong way if one starts by looking at the situation vis-a-vis individual countries. It is a systemic problem and it really has to do with the whole situation in all the debtor countries combined and the whole situation in the OECD.

And our trade deficit might be dramatically—I feel would be dramatically—reduced, if we adjusted exchange rates within the OECD. It is not an exchange rate problem between the dollar and the Korean currency. It is an exchange rate problem within the OECD.

And if we adjusted the imbalances in the growth rates in the OECD, then that would take care of the major part of the trade deficits.

Mr. Jones. I think, as we said this morning, U.S. business also agrees with what you are finding, Senator. If we got the dollar down and could keep it down, that would solve a very significant portion of our problem.

It might will be enough, perhaps, focusing particularly on the yen. But if the dollar can come down against all the OECD currencies, despite some continuing concern over the smaller trade deficit that would remain. I think it would ease the situation a great deal.

Senator Mathias. I want to just finish up because the time for this panel has really expired. I want to go back to Professor Tyson for just a minute.

I certainly agree with you that you have to have a comprehensive view of the whole deficit problem. But you are not suggesting that there has to be a single solution for every aspect of the problem?

Ms. Tyson. No, no. But I was suggesting that the wrong policy priority would be to start to spend an incredible amount of time to achieve a very difficult objective, which would be to fashion trade legislation on a country-by-country basis.

It seems to me that the amount of discrimination and knowledge it would take to do that right is so great that a better policy initiative would focus on the value of the dollar—I mean, you know, we have begun to do something about the dollar just recently.

But it seems to me that if you look at it historically, what we did is to create a system that was based on free trade. And then because of decisions which we and the other developed countries took, either explicitly or by not failing to act, we created an exchange rate situation and a debt situation which are grave threats to the free trade system that we created.

And it seems to me if you are going to think of policy initiatives, you think about initiatives concerning controlling the value of exchange rates so they don't get out of line so fundamentally.

And that this would be a better direction to move than trying to figure out the right trade bill for Brazil and the right trade bill for Korea.

Senator **Mathias**. But what about situations like Korea which has a very big defense contribution to make to this overall general security system in which we are engaged? If they were precluded from a significant portion of their trade with the United States, their attitude from maintaining that defense establishment might be different.

And then a totally different case, in Hong Kong, which I am told has a very free system of trade? We can't complain about improper trade practices with Hong Kong, but we have a big problem with particularly textiles coming out of Hong Kong.

A solution that might be applied to Hong Kong might be very different from a solution that would be required for Korea because different considerations govern. We could shoot ourselves in the foot in one country by applying too broad a solution to it.

Ms. **Tyson**. I agree, I agree. But to the extent that we are going to proceed with protectionist measures of any type, it seems to me we obviously have to pay attention to our own security interests and also our own economic interests.

Because it might be worse, given the extent to which we are interrelated with Mexico and Brazil, to have protectionist measures directed at them than to have protectionist measures directed at some other country in East Asia that we are not so directly dependent on.

So if we are going to follow that route, I agree with you, one needs to take country specifics into account. I was more arguing against the general route.

Senator **Mathias**. Well, I think on that point we had better adjourn this panel.

That you very much for being with us.

Now, our next and final panel for the day is the panel on "Oil Flows," and on that panel we have Professor Teece, who is from the School of Business Administration, University of California at Berkeley. And he will be joined by William B. Hermann, chief economist of Chevron.

Mr. **Jones**. And also Mr. Dorman Commons, the retiring CEO of the Natomas Oil Co., who will be here joining us in the discussion of the first two papers, as one of our oil experts from the world of business.

Senator **Mathias**. We appreciate his being with us. Which of you gentlemen would like to begin?

Mr. **Hermann**. I am indifferent.

Senator **Mathias**. Well, take it alphabetically then. Start with Mr. Hermann.

STATEMENT OF WILLIAM D. HERMANN, CHIEF ECONOMIST, CHEVRON CORP.

Mr. HERMANN. I would like to address my comments to two major areas of concern in the petroleum industry which I believe have implications for "Sustaining U.S. Economic Growth," which is part of the topic of discussion.

It is my judgment that growing and dynamic industrial economies will provide expanded markets for the less developed countries and thus contribute to an earlier resolution of their considerable debt problem.

However, there are two major impending constraints which, if not resolved very soon, will inhibit the ability of the petroleum industry to contribute to U.S. economic vitality. I am referring to our access to additional energy resources and our ability to finance their development.

Despite the lower levels of demand today, we still have to import about a third of our crude oil and petroleum products. Last year, those imports cost our Nation a total of more than $57 billion.

For this and other reasons the industry continues to maintain a vigorous domestic exploration and development program.

Obviously, the outlook for the price of crude oil and petroleum products is a critical factor in determining how much we can afford to invest to develop new sources of oil and gas.

Most of this oil will have to come from two principal sources, frontier exploration, primarily offshore, and from enhanced recovery. Both require government permits of one sort or another, and both involve heavy front-end investments by the oil industry.

Unfortunately, we still face many obstacles that affect both the industry's access to frontier exploration areas and our ability to finance new petroleum development.

Despite the fact that our industry has clearly demonstrated that it can find and produce petroleum safely in offshore waters, without harm to the environment, we continue to face unrealistic objections to offshore drilling. As a result, more and more of the most promising offshore acreage has been declared off limits to petroleum exploration.

Many of our elected representatives also cling to the persistent misconception that the oil industry can be taxed more and more heavily without crippling its ability to provide the fuel and power our Nation needs for its economic growth.

Contrary to popular belief, petroleum is the most heavily taxed major industry in the United States.

The most recent staff study by the congressional joint committee on taxation shows that as a percent of pretax income, the petroleum industry's Federal income tax payments are higher than the average for other major industries.

And when you add the so-called windfall profit tax, which is really a direct tax on production, the total Federal tax burden of the 21 leading oil companies over the past 5 years was nearly twice that paid by the 100 leading nonoil companies.

To add to our industry's already disproportionate tax burden would be another setback in our Nation's effort to maintain a reasonable level of energy self-sufficiency. It would further reduce the amount of capital available for exploration and development.

And that, of course, will mean an even faster decline in domestic oil and gas production at a time when our Nation is already facing the prospect of becoming more and more dependent on foreign energy.

In its present form, the administration's tax reform proposal is really a massive retroactive tax increase on U.S. business. It would repeal the investment tax credit and change the depreciation rules which were voted into law only 4 years ago.

Yet those are the very tax incentives which stimulated a great deal of the investment leading to the recovery from the recession of the early 1980's.

Eliminating the investment tax credit and the more equitable depreciation rules would have the opposite effect. It would discourage investment, eliminate jobs and make it more difficult for U.S. industries to be competitive overseas.

Another initiative under consideration is an oil import fee which I think Mr. Teece is going to talk about—and I am going to disagree with him on it—although it would seem to provide incentives for domestic oil and gas production, still amounts to an additional tax on petroleum in the United States.

An import fee would also violate the administration's free trade philosophy as well as render U.S. goods more expensive in world markets, thus worsening our trade balance.

Only a growing and dynamic U.S. economy will provide the markets required to help Third World countries recover from their economic woes. Oil companies can assist in this effort if they are permitted to explore for energy where it is most likely to be found, and if they are not penalized economically by an ever-increasing tax burden.

I realize, Senator, that these remarks are very focused on the oil industry which I believe you desired. I would be glad to broaden these views in further discussion.

Senator MATHIAS. I think it is very important to focus on the oil industry because after all it is a key factor. Energy is the lifeblood of modern economy. And oil is a principal form of that, a principal source of energy. So I am very much interested in it.

I think we need to understand a little bit more about the petroleum economy. There was general shock when oil prices went up as high as they did. And therefore, I think there is a general perception that it would be wonderful if oil prices go back as quickly as possible to the levels from which they came.

People have nostalgic memories of 25 cent gasoline, 35 cents a gallon for gas. I think they would like to have that back again. But I think we need to look realistically at whether there is such a thing as too low a price for oil, as well as too high a price for oil.

So I am very much with you in focusing on that. And let me turn to Professor Teece.

Mr. TEECE. All right, I would like to submit a written statement for the record which is coauthored by Prof. Connie Helfat from U. C. Davis.

Senator MATHIAS. It will be included as part of the record.

STATEMENT OF DAVID J. TEECE, PROFESSOR OF BUSINESS ADMINISTRATION, UNIVERSITY OF CALIFORNIA AT BERKELEY

Mr. TEECE. Thank you. I want to focus on the impact of low oil prices on the debt problem.

I don't believe this is a hypothetical exercise, as we have already seen prices come down some. But I fully anticipate, as do many others, that we are going to get $20 a barrel oil and maybe $15 a barrel oil in this decade.

Not everyone agrees, but nevertheless the probability is high enough that I think we have to take it into our contingent planning.

And it is going to come down basically because the oil producing nations, in search of more revenues, are going to expand production. The Saudis have indicated they are going to do so. There is no cohesion within OPEC. As they increase output and as prices begin to come down, other countries will respond by increasing output as a way to try and recapture revenues which they have lost.

Given that there is at least 12 million barrels a day of excess capacity out there in OPEC, the effect of this if it is not controlled by OPEC—and I don't believe it can be or will be—is that we are going to be looking at oil prices considerably below what they are today.

What does this mean for the world economy? And what does it mean to the debt crisis?

The first and most obvious thing that I want to point out is that it means that the major oil importing nations will pay less for their oil imports. This relates to your remarks earlier, Senator, about the effect upon all those little countries that we sometimes forget about.

Many of those little countries import oil. And they will be better off as a result of having less to pay in imports.

Some big countries including the United States and Japan will also be better off. Because while we are certainly producing more than two-thirds of the oil we consume, we are still a significant importer.

It is expected that with lower oil prices there will be a slight uptick in world economic growth. In fact, most estimates are that a 10-percent fall in the price of oil will generate about a 0.2 percentage point increase in world economic growth, which means if you get a substantial fall in price, greater than $10, that you may well get as much as an extra percentage point increase in world economic growth, and you will also get somewhat lower inflation and somewhat lower interest rates.

But what about the impact debtors and oil exporters? There are clearly a group of countries out there that are going to benefit, namely the oil importers. There are some producers, such as the Saudis and the Kuwaitis which are not in debt and are capable of taking and living with lower oil revenues in my view.

But there is a group of other countries which include Nigeria, Mexico, and Venezuela—possibly even Egypt—which are heavily indebted already and which are relying on exports of oil as a way of not only meeting interest payments, but also retiring principal at some point.

What we have done in our study is to look at the data as they relate to Mexico and Venezuela, to see what impact lower oil prices have on their ability to service their debt.

And as you might well expect, even taking optimistic assumptions about world economic growth and about their ability to export, both of these countries are in serious difficulties, Venezuela more so than Mexico primarily because it is more dependent on oil export than is Mexico.

I will simply refer to our written testimony which provides the data and the calculations. It is enough simply to say that there is a problem, and that that problem is of sufficient magnitude that it is going to require some kind of response from the industrialized nations.

And given our special relationship with Latin America, as well as our special role in the world economy, there is no doubt in my mind that the United States is going to be involved in one way or another.

So the question that I think we have to think about is what are the most appropriate policy responses to the forthcoming debt crisis. And I am keeping in the background the basic development problems we have, even with prices where they are, and the solutions that have been suggested by Fishlow and others I basically go along with Fishlow's concern about the need for long-term capital for economic growth.

I am not going to address the developmental issues raised by others who have testified. Rather, I am going to focus specifically on what to do about the shortfall in revenues caused by a substantial fall in world oil prices. At least to some degree, I believe the problems of providing adequate development finance and responding to lower oil prices are separable. The problems are separable because if we get low oil prices this decade, as I expect we will, sometime in the nineties and certainly by the year 2000 prices are going to rise up again because the demand-supply balance will favor higher real prices at some future date.

So these countries that have significant reserves have basically a short-term to medium-term problem with respect to oil prices. In the long run oil prices are going to increase again—we don't know exactly when nor do we know exactly by how much—but they are going to increase.

And so in some sense we are talking about a long-term financing problem—at least that is the way I like to think of it. And when thinking about solutions, I also think we have to keep in mind what you were pointing to earlier Senator Mathias, namely, that the rank and file—American citizens—don't want to pay any more than they have to to solve these problems.

So I am trying to think about——

Senator **Mathias**. The rank and file's judgment is made at the gas pump.

Mr. **Teece**. That is right, the rank and file's judgment is made there. But they are also very reluctant to have you vote for what is tantamount to unilateral transfers, be they explicit or implicit. Unilateral transfers are difficult to manage politically when domestic needs are not being met.

So I have come up with a a three-prong solution to the debt problem which I anticipate will be upon us soon. The first one is that the United States—and this would be triggered when oil prices hit $20, which may well be next year sometime—that the United States resume filling the strategic petroleum reserve.

Congress has already authorized the reserves to be filled to capacity, which is 750 million barrels. The administration has basically put a moratorium on filling the reserves at approximately 500 million.

So there is an action which is in our own economic and security interest, namely filling that reserve which we could take immediately, which would certainly require cash, but it would provide—depending on where the world oil prices were—would provide, $5 billion at $20 a barrel.

And we could target that at Venezuela and Mexico and say, OK, we are only going to buy from Venezuela and Mexico to fill the reserve, and we will also require that this oil comes from incremental production.

So they can capture additional revenues by producing more while also meeting a security goal considered by the Congress to be critical.

If you plug that $5 billion into our balance of payments model, and spread it out over 3 years, it helps some in terms of the ability of Venezuela and Mexico to meet their interest payments. It doesn't solve the entire problem, but we have at least got something—a mechanism that will work for about 2½ years if we fill up the reserve at the rate of 250,000 barrels per day, as I would propose.

The second prong in my proposed solution is that the United States be prepared to negotiate with Mexico and Venezuela for take-or-pay contracts for the purchase of crude oil. Take-or-pay contracts are a mechanism which is used in industry to purchase natural gas, coal, and various other resources.

The basic idea is that the buyer commits to buy according to a certain schedule, say 100,000—or perhaps $500,000 barrels of oil per day. If we don't take the oil today, we pay for it anyway but we have the right to take delivery of that oil in the future.

So in one sense what you are doing is guaranteeing to these countries a constant income stream. You are guaranteeing a stream of payments for oil purchased at agreed-upon prices. These prices can be negotiated up front.

And if for various reasons the United States doesn't want to take the oil today, then it would have a claim for future delivery. Assuming delivery is postponed, in essence the United States ends up buying reserves of petroleum in the ground. And these countries, Mexico in particular, are very rich in petroleum. Those reserves are going to be valuable in the next century.

And Venezuela is not only rich in petroleum, though not as rich as Mexico, but it is rich in alternative sources of fuel as well. So this is a feasible solution.

I suppose one question that one could ask is, if it is such a good arrangement why doesn't the private sector do it anyway, or why haven't market forces led U.S. business to negotiate take-or-pay contracts?

And there are two obvious reasons for that. The first one is enforcement. Namely, you are paying up front for a promise that the oil will in fact be delivered sometime in the future.

Now, private parties don't have the same ability as governments, particularly in international commerce, to enforce those kind of contracts. So it doesn't surprise me that private parties wouldn't step up and attempt to do this.

The second reason is that we are talking about take-or-pay contracts that may be 10–25 years in duration. We are talking about long-term sources of funds being necessary to exercise these contracts if delivery is postponed. And once again, that is an area where the financial institutions have not had excess supply in recent years.

I don't mean to downplay the enforcement problem. I think that even if the Government is involved in negotiating these contracts, there is a very real question, as there is with long-term loans, as to whether or not these contracts are going to be honored if we pay before we take.

So I would also require that certain fields be dedicated to these contracts, namely, certain oil fields should be set aside to service these contracts, and that it be very clear that the contract was being violated the minute a barrel of oil from that field went to a destination other than that specified by the buyer.

So it would give us a tangible asset in the ground to secure the loan against, rather than something ephemeral like a slice of a debtor nations GNP 20 years hence, which is what really goes on when one negotiates long-term bank financing.

This policy need not have any ultimate cost to American taxpayers. Indeed, take or pay contracts might prove profitable if buyers guess right about future prices.

But nevertheless, there is a financial cost in the sense that there is a carrying cost up front, namely, that someone has got to pony up a lot of cash maybe for 10 or 15 years to support this concept.

And in an era of budget deficits, that is always hard to come by, which brings me back to a hobby horse that is going to invoke wrath from my left-hand side here.

And that is, that the United States should in any case have a tariff on imported oil. And as the world price falls, as I am predicting it will, the case for the tariff gets even stronger.

We need it as a matter of national security inasmuch as with lower oil prices we are going to have more imports coming in, we are going to be more strategically exposed somewhere down the road.

The tafiff, in addition, does something else which is going to be very useful in this context. And that is, if you are talking a $5 or $10 tariff, you are going to raise domestic prices. So suppose the world price was to fall to $15, by the time you put a tariff of say $10 on, you are back to a domestic price of $25. Of if it is a $5 tariff, a domestic price of $20.

What that is going to do is the following. It is going to prevent a second debt crisis. We have got two debt crises to deal with if the world price comes down to $15. We have got an international debt crisis, and we have also got a domestic debt crisis because there is a lot of banks, particularly in Texas, that are out long on loans to oil producers.

And at around $20 a barrel, I am worried that a number of those large regional banks will go under and require a Federal bailout.

The tariff will keep domestic prices up, provide incentives for production and reduce the risk of domestic default. It is much easier to deal with the international debt problem if you are only fighting on one front, namely, internationally.

If the banks have got problems with loans nationally as well as internationally, then there is a problem for which the solutions are really more difficult.

The final aspect of the tariff—and I am somewhat ambivalent about this—is that it yields revenues for the Federal Government, large revenues. Because not only do you get the tariff revenue, but also it is going to raise domestic prices above what they would otherwise be and you get a kicker from the windfall profit tax.

And depending at what level domestic prices end up, you could end up generating on a $10 tariff $30 billion. I mean, this is one of the few big money winners that the government has at its disposal.

Talking as a professional economist, I would say that these revenues should be transferred back in the form of rebates or tax reductions somewhere. But if you look at the realities of the political environment today and the problem of budget deficits, and the other part of this package that somebody has got to ante up some cash up front to make this take-or-pay concept work, then you need a source of revenue. And the tariff would provide more than is necessary to fund these programs up front.

There is no long-term cost to the economy with my 3-point proposal unless you have bad luck in guessing future oil prices. But there is a financing need up front, and that is where the tariff would come in. The take-or-pay contract could be funded from general revenues, but I think that given the total political environment, as I see it, the tariff makes awfully good economic sense. And it is not too bad politically either, from what I can tell.

Senator **Mathias**. Just one quick question before we turn to Mr. Commons for his discussion.

You say there is no long-term cost?

Mr. **Teece**. Yes.

Senator **Mathias**. What about the impact at the gas pump of the $5 tariff?

Mr. **Teece**. Oh, of the tariff?

Senator **Mathias**. Yes.

Mr. **Teece**. The tariff need not have a cost on the consumer at the gas pump. I didn't emphasize in my written presentation, I have actually been advocating a tariff as the mechanism to get the world price down.

Because if the United States reduces its demand for oil in the international marketplace, the probability that we could unravel OPEC is greater. And we should have done this years ago. If a tariff in the United States did depress world oil prices, we would end up paying no more at the pump. It would really end up being a transfer from the Treasuries of Saudi Arabia, Kuwait, Abu Dabi, and other oil exporters to the Treasury of the United States of

America, which isn't such a bad arrangement from the point of view of our own narrow economic self-interest.

If the price goes down to $15, and then we put on a tax or tariff, then it is not going to drive the world price down any more—or not much more—because once it gets to $15, OPEC, as a phenomenon, is gone. We are looking basically at a competitive market.

And the tariff would then raise gasoline prices up close to where they were before, depending on the magnitude of the tax. So consumers don't see anything. They end up paying no more than they're paying now.

But the Treasury sees a big inflow of cash, first of all from the tariff revenue and, second, from the windfall profit tax.

The amount of the windfall profit tax is difficult to calculate. It depends on exactly at which price you impose the tariff and how much tier 1, tier 2, and tier 3 oil there is around, and so forth.

[The joint prepared statement of Ms. Helfat and Mr. Teece follows:]

Oil Prices and the Debt Crisis

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Oil Prices and the Debt Crisis

I. INTRODUCTION

The conventional view, fortunately not shared by everybody who has testified in these hearings, is that the debt problem has now been deescalated, and that there is room to breathe easily. Several policy analysts have recognized that new risks to the international financial system will follow from a major change in oil prices, either upward or downward. The sharp escalation of oil prices during 1973-74 and again in 1979-80 was a major cause of the debt burden of developing countries in the first place.[1] Further escalation above the $30 range would clearly aggravate problems. What is less clear is the impact of markedly lower oil prices.

In our view, the prospect of markedly lower oil prices is more than a theoretical possibility. It is the most likely outcome. For reasons to be explained shortly, we anticipate oil prices in the $15/barrel range this decade, if not next year, especially if certain policy initiatives are adopted in oil importing nations.

We analyze the impact on two key debtor nations of great importance to the United States, Mexico and Venezuela. Our analysis shows that the price scenario we expect will create serious problems which will require the U.S. to take certain policy initiatives, for reasons which transcend the debt problem and the stability of the international financial system. However, these policy initiatives can be fashioned so as to surmount the debt problem without seriously conflicting with other U.S. economic policy goals. Markedly lower oil prices thus expose the international financial system to new threats and challenges, but creative approaches exist which can help relieve the developing country debt situation without placing excessive burdens on the industralized nations.

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[1] Nondeveloping countries which are oil import incurred about $260 billion in additional oil imports expenditures over the period 1974-82 as compared to what they would have paid if the price of oil had risen no more than the U.S. wholesale price index after 1973. Oil exporting developing nations did not achieve corresponding export gains that made their debt lower than it would otherwise have been. Mexico, for instance, first borrowed heavily to develop oil production and used projected oil revenues as a basis for borrowing abroad to fuel a high growth strategy. The net impact of higher oil prices was a huge increase in developing country debt (see Cline, 1984, pp. 10-11).

II. $15 - $20 BARREL OIL

There is at least 12 million b/d of excess producing capacity currently available within OPEC, with a very good chance that more could be quickly added if the political will existed to do so. With the demand conditions most likely to prevail throughout the remainder of this decade, this capacity must be kept off the market if current prices are to be maintained.

If one believes that OPEC is a water tight cartel, forged in time of crisis, cemented together through a decade of challenges, and resolute in facing the future, then there is every reason to believe that the current price structure can be maintained. However, our view of OPEC consistently maintained since 1981 (Teece, 1982; Griffin and Teece, 1982a), is that it is really not a cartel at all, and that the price structure is extremely fragile. In particular, we believe that several OPEC nations are willing to let unused capacity lie idle only so long as they do not perceive their development goals to be jeopardized by inadequate oil revenues. Once pressures mount to recover revenues, individual producers, being unable to price above the market, will produce incremental barrels, the effect of which is to lower prices further, requiring even further incremental production. In this fashion, we anticipate oil prices to inch further downward. A sudden drop is possible, but a gradual slide towards $15 by 1987 is more likely. This is the view we advanced in 1981, and it is the view we still hold today.

Not everybody agrees with this price scenario, but most will at least recognize it as a possibility. Its achievement depends as much on political factors as on economic. The fact that our prediction stems from an analysis of OPEC behavior and internal structure, rather than from a full blown econometric model, in no way ought relegate it to secondary status, particularly in view of the abysmal track record of econometric forecasts. The foundations for our assessment of OPEC behavior are outlined more fully elsewhere (Teece, 1982; Griffin and Teece, 1982a).

III. THE IMPACT OF LOWER OIL PRICES ON DEBTOR NATIONS

William Cline (1984) has analyzed the influence of "low" oil prices on the balance of payments of 19 major debtor nations, 1982-86, assuming "base case" assumptions on industrial country growth, interest rates, and the dollar. His so-called "low" price scenario (1982: $34 barrel; 1983: $20 barrel; 1984: $20 barrel; 1985: $25 barrel; 1986: $25 barrel) is in fact a moderate scenario from our vantage point. With this scenario, Cline predicts that the current account deficits of the oil exporting countries would surge, raising the net debt-to-exports ratio to highly risky levels. Lower prices for oil would cause some improvement for oil importers, but not enough to offset the current account deterioration for the oil exporters. The reason is that oil exports are more vital to the oil exporters than are oil imports to the developing country oil importers. Cline's conclusion is that "the analysis here contradicts the view often expressed, including by some official sources, that sharply lower oil prices would tend to be good for developing countries and their debt problems because they are largely oil importers" (Cline, 1984, p. 58).

There is no doubt that lower oil prices will exacerbate the debt problem for several developing nations. However, we believe that it is extremely important to be cognizant of the magnitude of the problem, as well as the policy options available to deal with it. Accordingly, we have analyzed below the impact of $15 oil on both Mexico and Venezuela, two countries with high levels of indebtedness, and for whom U.S. policy accommodation may be politically feasible. These two countries are chosen because of their great economic and political importance to the U.S.

Mexico

We have examined the implications of lower world oil prices for Mexico's debt service and net debt in relation to export earnings. This exercise has been performed for two separate scenarios: one which assumes that Mexico achieves the same 5.5 percent per annum average real growth 1986-1990 as indebted developing countries as a whole achieved 1967-76 (our "high growth" scenario); and a second which assumes that Mexico achieves the same 2.5 percent per annum average real growth 1986-1990 as indebted developing nations as a whole achieved 1982-85 (our "low growth" scenario). Corresponding to each of these scenarios, we assume that the OECD base growth rates are 3.5 percent and 2.0 per annum respectively, which were the OECD actual growth rates for 1967-76 and 1980-85. The estimates derived for each scenario incorporate rather optimistic assumptions regarding Mexican current account performance. Specifically, we assume export elasticities of 3.00 (high growth scenario) and

1.5 (low growth scenario), and import elasticities of 1.0 (high growth scenario) and 1.1 (low growth scenario). We further assume that the international financial system requires very little debt amortization. The appendix contains further details with respect to the computations.

As shown in Table 1, even with optimistic assumptions, the high growth scenario implies ratios of both net debt and debt service to exports only marginally better than the present undesirable situation; in the low growth case, the ratios initially deteriorate before they improve. The table also illustrates the difference between the lower oil price regime and one with a constant price per barrel. In the latter case, the debt ratios improve through time, in part due to the optimistic assumptions incorporated in the estimates.

Mexico's performance is impaired by lower oil prices, but not disastrously so. With the optimistic export elasticities employed, the improvement in the debt service and net debt ratios which would occur in the absence of lower oil prices is basically neutralized. However, rapid deterioration in Mexico's debt ratios is possible and could be brought on by oil prices falling sooner and further than expected, by export elasticities lower than assumed, or by import elasticities higher than assumed. In short, Mexico's debt situation remains precarious, but lower oil prices do not necessarily push Mexico "over the brink."

Venezuela

Venezuela's current debt situation is much better than that for Mexico. Lower oil prices, however, would have a much harsher relative impact on Venezuela's debt because oil constitutes a much larger share of the country's exports than is true of Mexico.

Table 2, which depicts the high and low growth scenarios for Venezuela, shows the ratio of net debt to exports rising by about 45%. This contrasts with the predictions based on current oil prices that show improvement in the debt to export measures. In short, Venezuela's fortunes are completely turned by lower oil prices.

Implications

The high growth scenario, which we consider to be highly optimistic, shows the lower prices leading to enough growth in demand for imports in OECD to enable Mexico

Table 1

MEXICO

	1984[4]	1985[5]	1986	1987	1988
		High Growth - Declining Oil Price[1]			
Oil price/bbl[2]		25.60	20	15	15
NDX[3]	2.76	2.536	2.473	2.377	2.072
DSR[3]	.442	.385	.373	.354	.315
		High Growth - Constant Oil Price[6]			
Oil price/bbl		25.60	25.60	25.60	25.60
NDX	2.76	2.536	2.176	1.836	1.507
DSR	.442	.385	.342	.297	.265
		Low Growth - Declining Oil Price[7]			
Oil price/bbl		25.60	20	15	15
NDX	2.76	2.688	2.750	2.837	2.653
DSR	.442	.411	.410	.413	.387
		Low Growth - Constant Oil Price[8]			
Oil price/bbl		25.60	25.60	25.60	25.60
NDX	2.76	2.688	2.410	2.128	1.841
DSR	.442	.411	.374	.337	.299

Notes:

[1] OECD Growth Rates:
1985: 3%; 1986: 4.07%; 1987: 4.47%; 1988: 3.9%.
Mexican Growth Rate = 3.0% for 1985; 5.5% annually for 1986-1988.

[2] Current dollar amount.

[3] NDX = net debt to export ratio

$$= \frac{\text{total debt outstanding minus non-gold reserves}}{\text{exports of goods and services}}.$$

DSR = debt service ratio

$$= \frac{\text{interest + amortization}}{\text{exports of goods and services}}.$$

[4] Based on preliminary data from DRI. Not directly comparable to 1985-1988 estimates.

[5] Estimated based on 1984 data for the current account, interest and amortization, and debt outstanding, as well as on DRI growth rate forecasts and on current interest rates.

[6] OECD Growth Rate = 3.0% for 1985; 3.5% annually for 1986-1988.
Mexican Growth Rate = 3.0% for 1985; 5.5% annually for 1986-1988.

[7] OECD Growth Rates:
1985: 3%; 1986: 2.57%; 1987: 2.97%; 1988: 2.4%.
Mexican Growth Rate = 3.0% for 1985; 2.5% annually for 1986-1988.

[8] OECD Growth Rate = 3.0% for 1985; 2.0% annually for 1986-1988.
Mexican Growth Rate = 3.0% for 1985; 2.5% annually for 1986-1988.

Table 2

VENEZUELA

	1984[4]	1985[5]	1986	1987	1988
		High Growth - Declining Oil Price[1]			
Oil price/bbl[2]		26.05	20	15	15
NDX[3]	1.203	.963	1.055	1.267	1.404
DSR[3]	.393	.341	.337	.357	.372
		High Growth - Constant Oil Price[6]			
Oil price/bbl		26.05	26.05	26.05	26.05
NDX	1.203	.963	.732	.526	.358
DSR	.393	.341	.284	.232	.185
		Low Growth - Declining Oil Price[7]			
Oil price/bbl		26.05	20	15	15
NDX	1.203	.962	1.035	1.300	1.387
DSR	.393	.350	.346	.377	.392
		Low Growth - Constant Oil Price[8]			
Oil price/bbl		26.05	26.05	26.05	26.05
NDX	1.203	.962	.695	.439	.195
DSR	.393	.350	.288	.228	.171

Notes:

[1] OECD Growth Rates:
1985: 3.0%; 1986: 4.07%; 1987: 4.47%; 1988: 3.9%.
Venezuelan Growth Rate = 2.1% for 1985; 5.5% annually for 1986-1988.

[2] Current dollar amount.

[3] NDX = net debt to export ratio

$$= \frac{\text{total debt outstanding minus non-gold reserves}}{\text{exports of goods and services}}.$$

DSR = debt service ratio

$$= \frac{\text{interest + amortization}}{\text{exports of goods and services}}.$$

[4] Based on preliminary data from DRI.

[5] Estimated based on 1984 data for the current account, interest and amortization, and debt outstanding, as well as on DRI growth rate forecasts and on current interest rates.

[6] OECD growth rate = 3.0% for 1985; 3.5% annually for 1986-1988.
Venezuelan Growth Rate = 2.1% for 1985; 5.5% annually for 1986-1988.

[7] OECD Growth Rates:
1985: 3%; 1986: 2.57%; 1987: 2.97%; 1988: 2.4%.
Venezuelan Growth Rate = 2.1% for 1985; 2.5% annually for 1986-1988.

[8] OECD Growth Rate = 3.0% for 1985; 2.0% annually for 1986-1988.
Venezuelan Growth Rate = 3.0% for 1985; 2.5% annually for 1986-1988.

to lower its net debt to export (NDX) ratio, and to lower its debt service ratio. There is no calamity for the international banks. Venezuela presents a different picture with net debt relative to exports increasing, and debt service along with it.

In the low growth scenario, which we consider more realistic in terms of OECD growth, Mexico just maintains a holding operation with respect to key financial ratios, while Venezuela becomes impossible. In any event, we do not see the low growth scenario, implying as it does that Mexico and Venezuela would be stagnant for the rest of the decade, as being desirable either for these countries or the U.S. Nor for that matter do we consider it feasible.

This is not to imply that we consider the coming oil price drop to be an unmitigated disaster. To the contrary we see it as a major opportunity for the non-OPEC developing world as well as for the industrialized nations.[2] However, several imaginative policy responses are required, for which U.S. leadership is essential. A tariff on imported oil and petroleum products is part of our proposal. So is filling the strategic petroleum reserve, and possibly expanding it further. In addition, we advocate take or pay contracts between the U.S. and certain oil exporters as a mechanism of providing long-term capital for the exporters, and for providing the U.S. with favorable access to reserves.

IV. A TARIFF ON IMPORTED OIL AND PETROLEUM PRODUCTS

For quite some time now a tariff on imported oil and petroleum products has been warranted. The United States and several other oil consuming nations could improve their economic welfare through the imposition of a $5-$10 per barrel tariff. Such a tariff is warranted as a matter of economic efficiency and national security, and it would improve the economic welfare of the United States. An incidental effect, which many would label as a side benefit in todays world of excessive budgets and apparently uncontrollable budget deficits, is that the tariff would yield substantial revenues to the U.S. treasury.

We first publicly advocated a tariff in 1981 (Griffin and Teece, 1982a, 1982b). The case for it is stronger today than it was then, and will be even stronger if oil prices go to $15 a barrel. The arguments for it are briefly recapitulated below:

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[2] The U.S., for instance, would have saved about $19 billion on its oil import bill last year if oil prices had been $10 per barrel lower.

(a) National Security

Imported oil is subject to supply disruptions that could impose large costs on the American economy. A tariff would tend to favor domestic production over imports. In its absence, crude imports would escalate, particularly if the $15 price scenario unfolds. This would expose the U.S. economy to greater import dependence in the 1990s, with the strong possibility of another price or availability shock a decade or so from now.

(b) Economic Power

The present world oil price is not competitive, and a pricing structure exists which distorts the marketplace. A tariff would help bring about a more competitive pricing regime because in our view the decreased demand for OPEC oil would hasten the final unravelling of what is a fragile pricing structure within OPEC. The $15 price scenario which we view as likely would become a certainty, particularly if other countries were to implement policies which would reduce energy consumption and/or stimulate domestic production.

(c) Revenue Enhancement

Our analysis indicates that a tariff is justified on grounds of national security and U.S. economic self interest. In today's political environment, with our apparent impasse on budget reductions, one must recognize that a tariff would generate significant revenues for the treasury. Tariff revenues[3] of about $8.8 billion for a $5 tariff and $16 billion for a $10 tariff would probably be doubled or possibly even tripled by additional revenues from the windfall prodits tax, the exact amount varying according to the impact that the tariff has on domestic prices. If the budget was in balance, the revenues from the tariff should offset other taxes. Given the overriding importance of achieving a significant reduction in the deficit, we would advocate holding a rebate in abeyance for the next five years while a balanced budget package was being implemented.

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[3] A tariff of $5 on 1985 projected imports of 1,758,205 mm b/yr (derived by simply extrapolating average daily imports of 4.817 mm b/d through 6/85) yields $8.8 billion per year. $10 yields $17.6 billion. A tariff is also likely to drive up domestic prices, and hence the tax take from the windfall profits tax. The exact amount of revenues is very sensitive to the impact of the tariff on world prices. There is good reason to believe that the incremental revenues from the windfall profits tax would at least match the revenue from the tariff, at least until 1991 when it is scheduled to be abolished.

(d) Policy Flexibility

With $15 oil, the debt problem becomes unmanageable for certain developing countries. Assistance will be required from the United States and other industrialized nations if a major crisis is to be avoided. In our view this is quite feasible. If we adopt certain imaginative proposals, both the United States and the developing country debtor nations can be made better off. The direct benefits to the United States stemming from lower oil prices should enable us to accommodate several oil exporting debtor nations so that the debt problem recedes and economic growth is restored. With lower oil prices sufficient degrees of freedom should exist in the policy environment to permit improvement over the current status quo. If a tariff is in place the policy choices available will be richer than otherwise, and the accommodation of debtors politically easier.

If crude oil falls to $15 a barrel, economic growth in the U.S. and the industrialized world will accelerate, inflation will fall, the bill for imported oil will fall, and lower interest rates and a lower budget deficit are possible. However, two debt crises will be upon us. One will be domestic. In the absence of a tariff to hold domestic prices above international prices, certain oil producers will be in deep financial problems, and their banks along with them.[4] In addition, Venezuela and Mexico and possibly one or two other oil exporting developing nations will be in crisis. Many developing country oil importers with significant debt problems at present, such as Brazil, Korea, the Philippines and Turkey will benefit directly from lower oil prices and indirectly from the demand for their imports which higher economic growth will stimulate.

It is our belief that in this environment both the ability and willingness of the United States, and hopefully other industrialized countries, to deal with these problems will be enhanced. The tariff will enhance this capability for several reasons.

(i) By keeping domestic prices for crude and petroleum products from collapsing, the tariff will assist the banks in dealing with the loans of domestic oil producers. It is obviously easier to deal with a foreign debt crisis if one does not have to deal with a domestic one as well.

(ii) The revenues from the tariff will help reduce the budget deficit, facilitating additional appropriations and loan guarantees for the IMF and World Bank.

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[4] Several Texas banks have up to 1/5 of their loans out to energy related companies (see *The Economist*, July 6, 1985). If domestic oil prices were to fall below $20, we anticipate that at least one major Texas regional bank would be endangered.

An expanded capability for the World Bank and the IMF will be essential for dealing with the crisis. The U.S. must play its part in assuring this outcome. We must also encourage the Japanese and other beneficiaries of low oil prices to make additional contributions.

V. STOCKING THE STRATEGIC PETROLEUM RESERVE

A second and critical part of the policy response we propose involves ending the present moratorium imposed on filling the Strategic Petroleum Reserve. Congress authorized the reserve to be filled to the level of 750,000,000 barrels. Even though the reserve is only two-thirds full, the administration has placed a three-year moratorium on crude oil purchases. Should crude prices fall below $20.00 a barrel, we advocate the immediate lifting of the moratorium and the exclusive purchase of crude for the SPR from Venezuela and Mexico, so long as the purchases are met from incremental production.

Since the reserve will accommodate about 250,000,000 more barrels, this would permit either Venezuela or Mexico to supply an additional 250,000 barrels a day for a 1000 days, yielding $3.7 billion if world prices fell to $15 a barrel or $5.0 billion at $20.00 a barrel. In this fashion U.S. security needs are met while providing valuable short to medium term assistance to key debtor nations. Such a move is in the U.S.'s own interests, and ought to be engaged unilaterally. We wish to point out that we advocate filling SPR whether or not a tariff is in place in the United States. It makes good sense even without a debt crisis.

"Topping off" the reserve with incremental purchases from either Mexico or Venezuela also has a non-trivial impact on their current account. We calculate the impact in Table 3 for the low growth scenario only. Sharp improvements in the levels and trends of critical ratios are especially apparent for Venezuela.

VI. TAKE OR PAY CRUDE OIL CONTRACTS

The problem we see emerging for certain oil exporting developing countries from lower oil prices is a medium term problem. If oil prices fall to $15 a barrel through the 80s, they are likely to begin to rise again in the mid-nineties if not before, and real prices after the year 2000 will most likely be above today's real prices. This implies that the debt problem of oil exporters are in large measure problems of long term financing. Accordingly, we strongly favor making available various forms of

Table 3

Mexico

Strategic Petroleum Reserve (SPR) Purchases: Impact on Debt

	1984[1]	1985[1]	1986	1987	1988
Volume of Purchases	-	-	250 mb/d	250 mb/d	250 mb/d
Oil Price/bbl	-	-	$20	$15	$15
Value of Purchases	-	-	$1,825 bil.	$1,368.75 bil.	$1,368.75 bil
			Low Growth with SPR Purchases[2]		
NDX[3]	2.76	2.688	2.535	2.596	2.380
DSR[3]	.442	.411	.386	.386	.357
			Low Growth Without SPR Purchases[2]		
NDX[3]	2.76	2.688	2.750	2.837	2.653
DSR[3]	.442	.411	.410	.413	.387

Notes:

[1] No SPR purchases in 1984 and 1985. 1984 data based on preliminary figures from DRI, not directly comparable to estimates for 1985-1988. 1985 is estimated based on actual 1984 data.

[2] Low growth scenario as described in Table 1.

[3] NDX = (total debt outstanding - non-gold reserves) / exports of goods and services.
DSR = (interest + amortization) / exports of goods and services.

Table 4

Venezuela

Strategic Petroleum Reserve (SPR) Purchases: Impact on Debt

	1984[1]	1985[1]	1986	1987	1988
Volume of Purchases	-	-	250 mb/d	250 mb/d	150 mb/d
Oil Price/bbl	-	-	$20	$15	$15
Value of Purchases	-	-	$1,825 bil.	$1,368.75 bil.	$1,368.75 bil.
			Low Growth with SPR Purchases[2]		
NDX[3]	1.203	.962	.833	.969	.952
DSR[3]	.393	.350	.311	.318	.307
			Low Growth without SPR Purchases[2]		
NDX[3]	1.203	.962	1.035	1.300	1.387
DSR[3]	.393	.350	.346	.377	.392

Notes:

[1] No SPR purchases in 1984 and 1985. 1984 figures based on data from DRI; 1985 figures are estimated.

[2] Low growth scenario as described in Table 2.

[3] NDX = (total debt outstanding - non-gold reserves) / exports of goods and services.
DSR = (interest and amortization) / exports of goods and services.

long term financing, rather than direct or indirect forms of foreign aid, to oil exporting countries which have serious external indebtedness problems.

The long term financing instrument we favor is the "take or pay" crude oil supply contract. This form of contract, common for natural gas, coal, and electric power, typically defines minimum quantities which a purchaser will agree to take at specified prices, over a given time interval. If the oil is not taken, the buyer agrees to pay for the crude while reserving the right to recover it at a later time. Take or pay contracts can be written to assure producers of an outlet for a significant fraction of their crude and hence a predictable level of cash flow. This in turn facilitates the making of costly investments in production, and in the case of oil exporting nations it would permit them to pursue development goals based on long term rather than short term export earnings. A take or pay contract is tantamount to the buyer purchasing a claim over the production from certain reserves.

We are proposing that the United States government execute take or pay agreements of 10-25 year duration with certain exporting nations, for total volumes in the range of 500,000 barrels per day, at an agreed upon price. That price could simply be the spot price today tied to some escalator, or it could be any price schedule which the parties would find mutually acceptable. Our expectation would be that the U.S. would take the oil in the future, rather than now, although it should preserve its flexibility to take the oil at any time, possibly for an expanded strategic petroleum reserve. Indeed, in order to assist security goals, one might propose that the U.S. negotiate for the putting into place of surge capacity on reserves dedicated to take-or-pay contracts. Then when confronting "take" opportunities previously "paid" for, the U.S. would have surge capacity available on an as needed basis.[5]

The take or pay contract is an ideal instrument for dealing with the debt problem. It need not cost the U.S. anything in the long run, and in fact could yield large savings if we were able to negotiate prices for the future which turned out below actual market prices. Energy security goals could also be assisted. The efficiency of the instrument obviously depends on its enforcement; in this regard, it would probably be essential to require that certain oil reserves be physically dedicated to the contracts, and that "poaching" from these reserves would be considered an infringement of the contract.

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[5] The effect of this proposal, assuming it were honored by both parties, would be similar to that of expanding the strategic petroleum reserve. The proposal differs in that : (1) the SPR cannot probably be expanded rapidly beyond 750,000,000 barrels. It is generally quicker to negotiate a take or pay than to open up a new SPR. Of course, oil purchased under a take or pay agreement could be channelled into a new reserve once additional storage facilities were available. (2) It may well be cheaper to store oil in the ground than in salt domes, as it only needs to be pumped and transported once. (3) The disadvantage of a take-or-pay, from simply a security vantage, is that the mechanisms of contractual enforcement may not be perfect, particularly when foreign governments are involved.

That such contracts have not been privately negotiated already ought not to be surprising. Oil importers expect government assistance, in terms of supplies from the SPR, or an allocation program, if there is another disruption. Accordingly, they have little incentive to take costly measures aimed at reducing vulnerability. Secondly, private parties have weaker monitoring and enforcement mechanisms at their disposal than national governments. The exposure here is great, particularly if "take" opportunities are not exercised for a decade or more. Thirdly, the beneficiaries may include the international banks, and their "free rider" incentives are obvious. Hence, there is no reason to believe that market incentives are strong enough to bring about all responses desirable for the United States as a whole.

Conclusion

Lower oil prices will benefit the world economy and the United States. They also will provide an opportunity for oil importers to resume economic growth while adjusting to their debt service obligations. Lower oil prices will tend to exacerbate the debt problems of Mexico and Venezuela in particular; but the extra degrees of freedom existing in the international economy will enable the United States to deal with the problem in a more fundamental way, while simultaneously enhancing energy security goals. With effective bipartisan cooperation we believe that the U.S. is capable of responding to the great opportunity created by falling oil prices. The savings resulting from lower oil prices are presenting the U.S. and several of its allies with a splendid opportunity to lower the deficit, to augment strategic petroleum reserves, to expand the role of the IMF and World Bank, and to negotiate long term supply contracts with our beleaguered neighbors. We can reasonably expect something in return from the debtor nations that we move to assist. The enhancement of our energy security in the decades ahead ought to be part of the quid pro quo.

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Appendix

The equations used to compute the net debt to export and debt service ratios for Mexico and Venezuela follow those used by Cline (1984, pp. 240-244) with minor modifications. All estimates are based on 1984 data.[6] The estimates incorporate the impact of lower oil prices on OECD growth, inflation, and interest rates, as follows. A 10% drop in the price of oil is assumed to increase growth in the industrialized countries by 0.2% a year for two years; an $8 a barrel drop in oil prices is assumed to decrease interest rates by 0.68% and inflation by .75% over four years. The volume of oil exports for each country is assumed to equal 1984 exports.

As compared to the high growth scenario, the low growth scenario uses slightly less optimistic estimates of developing country export responsiveness to OECD growth and of import responsiveness to own country growth. Combined with the growth rates in the scenarios, these estimates imply that non-oil exports grow faster than imports. The estimates also incorporate 1984 amortization rates (best estimates) of country debt as follows: Mexico - 2.78%; Venezuela - 11.5%. For Mexico, in particular, this is a very low amortization rate. The estimating equations and values of key variables are shown below (subscript "t" denotes the year).

Equations

Value of oil exports in year $t = X_t^O$:

$X_t^O =$ (Annual volume of oil exports) $\cdot$ (oil price per barrel).

Value of non-oil exports of goods and services in year $t = X_t^{NO}$:

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[6] Data sources: Data Resources Inc., individual country letters; Morgan Guaranty Trust, *World Financial Markets*; International Monetary Fund, *International Financial Statistics*.)

High Growth: $X_t^{NO} = .97M_{t-1}^{NO}(1 + \mu_X g_t^{DC})(1 + \dot{P}_t)\left(\frac{d_t}{d_{t-1}}\right)$.

Low Growth: $X_t^{NO} = X_{t-1}^{NO}(1 + \mu_X g_t^{DC})(1 + \dot{P}_t)\left(\frac{d_t}{d_{t-1}}\right)$.

μ_X = export elasticity (responsiveness to developed country growth)

g_t^{DC} = annual rate of developed country growth in year t

$\dot{P}_t$ = world inflation rate in year t

d_t = index of nominal exchange rate per unit of foreign currencies, in year t.

Value total exports of goods and services in year $t = X_t$:

$$X_t = X_t^0 + X_t^{NO}.$$

Value of imports of goods and services in year $t = M_t$:

$M_t =$ $M_{t-1}(1 + \mu_Y g_t^i)(1 + \dot{P})(\frac{d_t}{d_{t-1}})$.

μ_Y = import elasticity (responsiveness to own country growth)

g_t^i = annual rate of own (developing) country growth

other terms as defined above.

Value of net interest payments in year $t = I_t$:

$I_t =$ $i_f(F)D_{t-1}^{LT} + r_t\left[D_{t-1}^{ST} + (1 - F)D_{t-1}^{LT}\right] - r_t^i H_{t-1}$.

i_f = average interest rate on fixed interest debt

r_t = interest rate on floating interest debt = London Interbank Offer Rate (LIBOR) + $1\frac{1}{2}$ percent

r_t^1 = interest rate on non-gold reserves = LIBOR - $1\frac{1}{2}$ percent

D_{t-1}^{LT} = long-term debt outstanding (in year $t-1$)

D_{t-1}^{ST} = short-term debt outstanding (in year $t-1$)

F = fraction of long-term debt at fixed rates.

H_{t-1} = non-gold reserves (in year $t-1$).

Value of transfer payments in year t, with 3% annual growth rate = T_t:

$$T_t = T_{t-1}(1.03)(1+\dot{P})\left(\frac{d_t}{d_{t-1}}\right).$$

Current account balance in year t = C_t:

$$C_t = X_t - M_t - I_t + T_t.$$

Annual change in reserves against imports in year t = ΔH_t:

High Growth: $\Delta H_t = \begin{cases} 0.2\,[M_t - M_{t-1}] & \text{if imports rise} \\ 0 & \text{otherwise.} \end{cases}$

Low Growth: $\Delta H_t = \begin{cases} 0.25[M_t - M_{t-1}] & \text{if imports rise} \\ 0 & \text{otherwise.} \end{cases}$

Value of direct foreign investment in year t, with a 3 percent annual growth rate = DFI_t:

$$DFI_t = DFI_{t-1}(1.03)(1+\dot{P})\left(\frac{d_t}{d_{t-1}}\right).$$

New net lending in year t = L_t:

$$L_t = -C_t + \Delta H_t = DFI_t.$$

(All current account surpluses are assumed to be used to reduce debt; current account deficits increase debt.)

Total debt in year t = D_t:

$$D_t = D_{t-1} + L_t.$$

Long-term debt in year t = D_t^{LT}:

$$D_t^{\mathrm{LT}} = D_t\left[\frac{D_{1984}^{\mathrm{LT}}}{D_{1984}}\right].$$

D_{1984} = total outstanding debt in 1984

D_{1984}^{LT} = long-term debt outstanding in 1984.

Short-term debt in year t = D_t^{ST}:

$$D_t^{ST} = D_t - D_t^{\mathrm{LT}}.$$

Annual amortization on long-term debt in year t = A_t:

$$A_t = aD_{t-1}.$$

a = amortization rate in 1984 = ratio of long-term debt amortization to end-of-year long term debt in 1984.

(Note that any unpaid short-term debt at year-end is assumed to be converted to long-term debt.)

Net debt to export ratio in year t = NDX_t:

$$NDX_t = \frac{(D_t - X_t)}{(X_t)}.$$

Debt service ratio in year t = DSR_t:

$$DSR_t = \frac{(A_t + I_t)}{(X_t)}.$$

Values of Key Variables in Equations

$\dot{P}$ = 5% initially; reduced if oil prices decrease.

$d_t/(d_{t-1})$ = actual ratio for September 1985 dollar exchange rate index compared with one year previous, for 1985 only;

all other years: value = 1.

LIBOR = 8 11/16 percent (current value).

F = 55 percent

a = Mexico: 0.0278

Venezuela: 0.115.

(D^{LT}_{1984}/D_{1984}) = Mexico: 0.954

Venezuela: 0.941.

i_f = Mexico: .1205

Venezuela: .126.

High Growth: g_t^{DC} = 3.5 percent beginning in 1986; growth rate is increased if oil prices decrease; 3 percent for 1985.

g_t^i = 5.5 percent beginning in 1986. For 1985: Mexico= 3 percent, Venezuela = 2.1 percent.

$\mu_X = 3.0$

$\mu_Y = 1.0.$

Low Growth: g_t^{DC} = 2.0 percent beginning in 1986; growth rate is increased if oil prices decrease; 3 percent for 1985.

g_t^i = 2.5 percent beginning in 1986; 1985 rates as in high growth scenario.

$\mu_X = 1.5$

$\mu_Y = 1.1.$

Senator MATHIAS. Mr Commons, you have heard these two witnesses. Where do you see the oil flows would go? Can they be too high and can they be too low?

Mr. COMMONS. Well, I am sitting between two distinguished economists. When I took my last course in economics in 1940, it puts me at a great disadvantage.

Senator MATHIAS. The world was easier to understand in 1940.

Mr. COMMONS. I think there is a great deal to be said for an import tax on oil. I would suggest that for several reasons. I don't think, first of all, that the total amount of the tax is actually going to get passed on to the consumer. I think what is going to happen is that it will drive down the price of foreign oil.

How much it will drive it down, I don't know. But I think it will have some impact. So I don't think all of it is going to be carried over to the consumer. And it will wind up in the Treasury.

I have a great deal of difficulty with the windfall profit tax. I think it is a very unfair tax and I think that it has actually helped to reduce the development of our own reserves.

And I would put the two together. I would phase out the windfall profit tax and impose the tax on imports. Because it seems to me that that makes much more sense than trying to maintain the windfall profit tax at the same time and imposing that burden on the domestic oil industry when we really do need to spend more money developing the domestic reserves.

And the way we are going now, if prices do fall $10 a barrel—and I am inclined to agree, at least from my observation, I think it is very likely that that is going to occur—that you are going to see us in a position where if all of the benefits are passed on to the consumer immediately, we are going to have an increase in the per capita use of energy, perhaps a significant increase.

It isn't just a matter of chance that U.S. auto makers are finding that there is an increasing demand for the larger automobiles and so on. This goes with the turf. And there is no question that at some point in the future, whether it is in 1995 or the year 2000, we are going to be back in shortage again.

And I think that anything we do to mitigate any unusual increase or excessive use of energy would be in the best interests of the country.

I think those are the comments I would make at this point.

Senator **Mathias**. Now, Mr. Hermann, I don't want to gang up on you.

Mr. **Hermann**. You mean, I get my rebuttal now?

Senator **Mathias**. Well, let me give you a further opportunity to rebut one more view on the subject.

Because we had a very interesting hearing in Washington not too long ago at which the witness was Paul Volker. And he came down very hard against any kind of tariff barriers to trade. He was very strong against any form of import tariffs with one exception.

And that exception was oil. And he took in part Mr. Teece's line, that he felt it was a conservation measure and would help to reduce consumption. But also that it would raise significant revenue for the Treasury at a time when we need revenue.

So now that you have got all that array of hostile testimony, why you can have a moment of rebuttal.

Mr. **Hermann**. I want to go back to a little bit of history concerning governments thinking that interference in these markets could at least tend to mitigate some of the evils which were perceived in late 1973, when the price of oil began to increase.

Let's look at Government policy during that period. We think we know the results of Government programs designed to improve market performance, but generally speaking we don't. Everything the Government did during that period exacerbated our energy problem.

We subsidized OPEC. We increased our consumption, and caused world prices to increase much more than they otherwise would have. All of this was done by Government. If Government had not instituted the crude oil entitlements programs and all of the product since controls that were in effect during the period, I think the free market would have produced much better results.

It wasn't a free market, of course, because there was a cartel out there. But a cartel is impotent, we are finding out now, in the face of market forces. The cartel cannot control prices, a fact which should not be surprising. There were people in my own company who were considering synfuel projects when the price of oil was going from $40 to $45 per barrel. They said, "Look, it costs only $5 billion and will be economic when the price of oil reaches only $60." And I would say "How does the project look at $20 per barrel of oil?" I am a great believer in market forces—if they are permitted to work. If we institute import fees and other market restricting programs now, we will not know what will happen to the price of oil. For example, Mr. Teece is talking about a trigger at $20 per barrel. I assume if oil prices shoot above $20 with some calamity in the world markets that the import fee would disappear. That is arguable.

Basically, I dislike the interference in markets. If you need revenue, tax something domestically.

Mr. **Jones**. That is what we are proposing.

One other thing, this is the only kind of tax I think President Reagan could convince (a) himself, and (b) the public that it wasn't a tax increase.

Mr. **Hermann**. Yes, because out of the public's view the Government collects an increase in the windfall profit tax. But as Mr. Commons said, I think that is a terrible mess.

The Government collects a third of the tax with an import fee, and you don't say anything about the two-thirds on which the Government collects approximately the same tax rate with the windfall profit tax.

Mr. **Teece**. I would go along with Dorman Commons and eliminate the windfall profits tax and put all the tax on the imported barrel if it is the burden on the industry that is of greatest concern.

The most important thing is to keep domestic prices up at least around the $25 a barrel range. Because then you avoid domestic bank failures and also you lock in conservation gains. And third, you deal with security to a minor degree inasmuch as you keep the dependence on imported crude down a little bit.

Mr. **Hermann**. But that is politically unacceptable.

Mr. **Teece**. Why?

Mr. **Hermann**. To let the petroleums industry have another $5 along with domestic production? That is politically unacceptable. Our profits would be in the headlines every time they were reported.

Mr. **Teece**. That is all right, I am just talking about what makes good economic sense.

Mr. **Hermann**. But it wouldn't be politically acceptable.

Mr. **Teece**. From here it makes good economic sense.

Mr. **Jones**. Keep the excess profit tax on and wind down the windfall profit tax if necessary.

Mr. **Teece**. Yes, you could balance it off so it is revenue-neutral on the industry if you wanted to, by winding down the windfall profits tax and picking it up on the import fee.

Mr. **Hermann**. But then, as I argued in my statement, you also tack on another penalty for everybody who exports—anything that is halfway energy intensive which gets exported again exacerbates our balance of payments problem.

Mr. **Teece**. Well, yes——

Mr. **Hermann**. I know what your argument is to that, another Government machinery which would rebate. And, you know, these things scare me. Government doesn't do these things very well.

Mr. **Teece**. All right, but you have got a problem there. You have got a debt crisis coming up that is looming up at you and will you stand back and do nothing?

And we are talking about choices amongst alternatives. And the question is, how does this lineup as compared to providing foreign aid, as to providing a bailout for the banks, and all the other things we are talking about.

And I think that it lines up in not too bad a way. My package will still fly without the tariff on imported oil. I mean, the important thing is to get revenue to the exporting debtor nations hopefully in exchange for something. That is why my idea is to get some oil back for whatever help we provide. That is at least better than giving it away.

And I think the American public will go along with that better than they will either direct foreign aid or disguised foreign aid in the form of a bailout for the banks.

Senator **Mathias**. I think that is a reasonable point because the Congress is sensitive on foreign aid questions. And countries that have a reputation of having had a high income from the sale of oil over an extended period of time are going to be looked upon with a good deal of suspicion.

As the object of Foreign Aid Programs, that would be a hard-sell job, no matter how justified it may be when that time comes.

Mr. **Hermann**. But I am not so sure—I don't believe in a lot of the scare tactics. Again, look at history. You remember when people were saying that the Saudis and the other oil-producing countries were going to accumulate $500 billion in 2 years and wreck the whole international financial community.

I said at the time, if you give people money, they spend it and they invest it. And that is precisely what happened. Everyone was saying the whole financial world would collapse because of the capital this accumulation which was going on with the oil-producing countries. But it didn't happen.

Mr. **Jones**. What they did, they overloaned it to Latin America.

Mr. **Hermann**. Yes.

Mr. **Commons**. They recycled it through the U.S. banks and loaned it to the developing countries. And now we have got a problem.

Mr. **Hermann**. We had a problem then. I am not any more affraid of the problem we have now than I was about the one we had then.

Mr. **Teece**. What if prices go to $15? Are you worried about Mexico and Venezuela? How do you think they will deal with it?

Mr. **Hermann**. Mexico and Venezuela will have a problem with their debt restructuring. But I was in the State Department at one time and sat out in West Africa when the price of raw rubber fell from 90 cents to 9 cents a pound. Europe was convinced that those rubber-producing countries were never going to be able to make it. It was admittedly small compared to some of the debts we see now.

But the IMF came in to restructure the debt, and they paid it off as far I know. They didn't go bankrupt. These things have a way of working themselves out.

Again, we had a great scare when the price of oil was increasing. The nations buying oil were the ones that we thought were going to go bankrupt.

A nation which is selling oil is still selling oil at $15 a barrel. That's better than the Sudanese who have a civil war on their hands and can't get the oil out to earn the foreign exchange.

Mr. **Teece**. I think that is a reasonable point. But, you know, if it looks like the international financial institutions aren't handling it—and your prediction is they can—and if they can, then we won't have to worry about it.

But if they can't, what do you do? And you are saying that we don't have to worry about that because it is unlikely.

Senator **Mathias**. Of course, it relates to the debt levels and the terms on which they are indebted. It is a little like the savings and loans problems in this country.

Mr. **Teece**. Right.

Senator **Mathias**. If you loan money at 5 percent and have to borrow it at 15, you are in trouble. If you get that kind of ratio problem, then they do have a difficulty.

But let me turn the spotlight on Professor Teece a minute and let you off the hook. Because I wanted to ask him whether he thought it is politically feasible in any country to agree to fix prices for oil on a delayed-delivery basis?

Won't that create some political problems, on the theory that they are giving away their own natural resources, their patrimony?

Mr. **Teece**. Political problems in the——

Senator **Mathias**. Yes.

Mr. **Teece** [continuing]. Exporting countries?

Senator **Mathias**. That they are squandering their patrimony.

Mr. **Teece**. Yes, I think that is going to be a hard sell. Because in the long term—if it operates they way I would want it to—is revenue-neutral to the United States. It is not costing us anything.

It means that it is not a give-away to someone else. Which means it is not going to be as attractive to the suppliers as other possible alternatives.

And I do think indeed that the notion that we might be owning oil out in the ground in Mexico that we paid for and we basically have a claim on it may be a political difficulty.

And my solution to that, if it did become a political difficulty, in other words if we paid under this contract for 5 years and we hadn't taken a barrel and it looked like it was becoming politically difficult, then we would start to take.

And we could do one of two things. We could then just sell it on the spot market, which probably wouldn't win us any favor with other oil producers. And the other thing we could do is, we could start opening up new salt mines and storing it in the ground.

Because, you know, many people believe that while we have got strategic petroleum reserve, it is not large enough.

Senator **Mathias**. But how do you apply these general operations to the precedent that we had with the natural gas deal with Mexico?

I was in Mexico sitting in the Pemex offices during that natural gas negotiation, and that was a fiasco of major proportions.

Mr. **Teece**. Yes. I think the timing is different. I mean, if Mexico is in trouble and we are engaging in reasonable steps to essentially help them on cash flow, it seems to me that hopefully there will be some recognition of, you know, at least we did them a favor when there was a problem.

When the other natural gas deals were arranged, Mexico, for instance, didn't need us but we needed the natural gas. So it wasn't in any sense symetrical.

This requires an institutional and political memory for it to work, I agree with that.

Senator **Mathias**. Mr. Commons.

Mr. **Commons**. Could I just ask David a question? Under normal take-or-pay contracts, are you required to pay the current market price for oil? If you say this is revenue- neutral for the United States, and you are not going to take production for 15 or 20 years, what are you going to pay for it?

Mr. **Teece**. Well, there are a number of ways. You could set the pricing—I mean, you could either agree to pay whatever the spot prices are now, or alternatively you can agree up front on some kind of price schedule covering the length of the contract. And that price schedule would be based on forecasts of prices for oil, and also the holding costs.

Inasmuch as you are paying for something now and taking delivery in the future, there is a holding cost. And that could be factored in.

I would basically imagine a pricing scheme that is based on negotiation and mutual agreement. And that can go just many different ways.

Mr. **Commons**. If it is really going to be neutral and you are not planning to take that production or take large parts of it for quite a long period of time, any scheduling that you use is going to produce a very low price per barrel for oil.

Mr **Teece**. That is right.

Mr. **Commons**. And I think you present Mexico or Venezuela with a critical problem in terms of selling oil cheap to the United States. Because that is what it will come out from a political point of view.

And here they are selling oil to the United States for $10 a barrel which the United States isn't going to get for 15 years. But nonetheless they have sold their future at a discount.

And I think that there are some real practical problems in terms of selling that kind of concept to a foreign goverment.

Senator **Mathias**. That was the suggestion I was making as squandering their patrimony by selling it too cheap.

Mr. **Commons**. Particularly at a discount. Otherwise, it is not revenue-neutral to the United States. If we pay tariff prices for it and don't produce it for 10 or 15 or 20 years, it doesn't take much of an economist to figure out that you have spent a lot of money.

Senator **Mathias**. Mr Hermann, do you have a comment?

Mr. **Hermann**. Yes. We were talking about the SPR, the strategic petroleum reserve. And I agree. I think that is something that Government can do, and does do well. And it should be there, and maybe we should have more in it. I will let the public judge that.

But remember that we were consuming nearly 19 million barrels a day when we established the SPR. And we established it on the basis of developing an inventory of 750 million barrels.

We are now consuming 15 million barrels a day. So the number of days of supply we now have in the reserve has gotten just about to the number of days of supply which was set on the original plan.

Senator **Mathias**. That is an interesting comment. I have one further question. But, Peter, do you have something to add?

Mr. **Jones**. Just one brief comment on Dorman's concern about either a discount price or full price.

Go back to David's key point, which is if any one of these economies like Mexico or Venezuela get into serious difficulty and it is in our national interest to help them out, you may be talking about concessional loans, you might be talking about grant funds.

There are all sorts of alternative ways that may be looked at for getting money down there. And what David is saying is even if you paid full price for oil, you would be getting more back that way than if you gave it away. Not a bad point, it seems to me.

Senator MATHIAS. I want to avoid the ignominy of being evicted here. And so we have to vacate in just a minute.

But let me ask you one question which may be a little bit off the point. It was suggested by one of you who mentioned the word "calamity," the effect of a calamity on world oil flows.

What would happen to oil flows, the petroleum economy, if the Iraqis make a lucky hit and take out Kharg Island?

Mr. TEECE. They have got most of it already.

Mr. HERMANN. It has been reported several times. But nothing happened to the spot markets or the futures market.

The fact is, there is such an overhang of supply out there now that I don't think the markets are worried about that. We could lose Iraq altogether.

Senator MATHIAS. Could you lose both Iraq and Iran?

Mr. HERMANN. Yes.

Mr. TEECE. Yes.

Mr. HERMANN. And Saudi Arabia. All at once, and it wouldn't make any difference. They are talking about closing the Strait of Hormuz now. It wouldn't make any difference. This is what we have bought with conservation and additional non-OPEC supply in the last few years.

Senator MATHIAS. I am going to pick you up bodily and take you to Washington to convey that news.

Mr. COMMONS. It would save a lot on defense.

Mr. TEECE. Better have Kharg fixed up 10 years from now, though.

Senator MATHIAS. Yes; but who can see that far over the horizon.

Gentlemen, it has been a very interesting, thoughtful and useful session. I appreciate very much your being with us.

If you have further afterthoughts or aftershocks, why we would be glad to include them in the record if you will submit them in writing. Thank you.

The hearing will recess now until the hour of 9 o'clock in the morning.

[Whereupon, at 4:40 p.m., the Subcommittee on International Economic Policy of the Committee on Foreign Relations was adjourned, to reconvene at 9 a.m., Thursday, October 10, 1985, in the same place.]

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U.S. ECONOMIC GROWTH AND THE THIRD WORLD DEBT

THURSDAY, OCTOBER 10, 1985

United States Senate,
Subcommittee on International
Economic Policy of the
Committee on Foreign Relations,
San Francisco, CA.

The subcommittee met at 9 a.m., pursuant to recess, in hearing rooms A, B and C, second floor, World Affairs Center, 312 Sutter Street, San Francisco, CA, Hon. Charles McC. Mathias (chairman of the subcommittee) presiding.

Senator **Mathias**. The subcommittee will come to order.

The first panel this morning on the subject of "Foreign Direct Investment and Technology Flows," will be Peter Jones and Professor John Zysman. I will ask Professor Zysman if he will lead off.

STATEMENT OF PROF. JOHN ZYSMAN, UNIVERSITY OF CALIFORNIA, BERKELEY

Mr. **Zysman**. Thank you, Senator, I appreciate that. I know Mr. Jones was supposed to go first, but I have to sneak back and actually do what I am supposed to do which is to teach class.

Senator **Mathias**. That may be setting a dangerous precedent, doing what you are supposed to do.

Mr. **Zysman**. I was asked to discuss some of the technology transfer issues in the context of the international debt problem. Because I am going to want to discuss some of the limits on what the United States should attempt to try, I would like to make my general position on the whole debt problem clear so that doesn't become confused.

It is clear—and I say these very quickly—the resolution of the debt crisis is an issue of central national importance. In fact, in the 1930's as I would see it, the collapse of the international trade system was more a product of the international financial collapse than it was of the international protectionism.

And therefore, we should be more concerned about this problem than the trade issues at this point.

For the indebted nations to pay their debts, the advanced countries and certainly the United States will have to leave their markets open to exports. And indeed, these imports by these countries and then balanced by our exports to them.

Third, the continued development of these countries is going to require infusions of capital, and particularly of public funds. Which leads us, of course, to the private investment issue and to the role that we might expect private investment to play.

I want to make four simple points. And I want to make those points with particular attention to American trade interests.

The first point is that we should not encourage the establishment in these countries of export platforms in order for the debtor nations to attract the United States direct product investment.

Now let me be clear why. Private investment for American firms to capture the potential of these growing markets is one thing. It is certainly important for American firms to establish themselves in these markets, even to encourage American exports into these markets.

But support for export platforms is really another matter. And there are two reasons why it poses in my view quite a serious problem.

One certainly is that there is the political problem of adding to the import surge since there is a limited political not economic ability to absorb those imports. Further imports in export platforms pose problems.

But more importantly, it has to do with American economic development and American strategies. As is clear, the United States is pressed in general by foreign manufacturers in labor intensive industries such as apparel and complex manufacturing industries such as autos and TV, and high technology industries, computers, semiconductors.

But in common to all of these problems is the weakening American domination of manufacturing processes, is the need to assure and maintain and master advance manufacturing.

But the real problem is that over the last years American has lost its distinct manufacturing advantage in a period in which products have become easier to copy. And the result is that American industry is increasingly competing on a price basis with the rest of the world, which is really reflected by the change in the volumes of imports that were pulled in by exchange rate changes as American prices become less competitive.

Simply, the problem with export platforms is that many American firms have in the past and are once again turning offshore in pursuit of cheap labor as a solution to their price competitiveness problems.

It is self-evident, it seems to me, that the United States can't compete with the rest of the world on wages. There are too many people out there who are willing to accept wages that are too low. We either have to innovate in automation or our firms will emigrate.

The problem is that in the past in the colored television industry, in earlier periods of the semiconductor industry, American firms moving offshore to try and find cheap labor solutions failed to innovate in manufacturing and lost their markets not because of the labor they could get in the United States wasn't cheap enough, but rather because they were beaten on the shop floor by manufacturing innovation, particularly from Japan.

And if consolidated with that problem, we encourage a repetition of that process, I think we will have very serious long-term problems. And so we should, I think, formulate our policies to encourage direct private investment into those markets for the purpose of selling in those markets, not selling back into the United States.

A number of companies, including Motorola as you may know, are now substantially thinking about moving—or are now thinking about moving substantial portions of their manufacturing assets offshore. And this I think will begin to become a pressing and urgent problem.

The second point I would like to make is that we must leave—in order to leave our markets open so that the LDC countries can resolve their debt problems, we must begin to pursue domestic policies to facilitate trade adjustment inside of the United States. It was true in the 1960's, and the growing pressures in the United States for protectionism will only be met, not by rhetoric and not by political resistance, but by real policies both in the labor area, and particularly relating to the first point, in the area of promoting manufacturing innovations and helping firms adjust to the pressures that they are facing.

The third point that I would like to make is that in considering foreign technology strategies, an important part of the private investment discussion, we need to get our priorities straight. And I think that they really have not been.

In recent speeches—certainly some that I have heard—the administration has emphasized that it wishes to pull down barriers abroad to American exports. And in the talks I have heard, there has been an emphasis on pulling down barriers in Japan in leather, and in Brazil in computers.

A friend of mine who also heard the speech by the Vice President asked if he hadn't misspoken, didn't he mean Japanese computers and Brazilian leather. And I replied that he meant what he said but I thought that he had got it wrong.

And I think that the issue of technology transfer into these countries, and the kinds of roles and policies we should pursue in supporting American firms entry, need to be reconsidered.

We have a fear that unless American firms implant themselves, there will be a repeat of the Japanese experience. And certainly the Brazilians and other countries would like to use Japan as a model. Close off your markets, force the transfer of technology, build your domestic industry, and then reexport.

I think that that is not a legitimate fear on our part. And I think we should in fact tolerate those policies at this point. The policies, mind you, not going to work for several reasons.

There is no real room for another technological giant at this point. The same conditions that permitted Japan to succeed 20 years ago in these industries are simply not there, particularly the existence of a consumer electronics base which was the basis of Japan's surge.

Second, these goods are intermediary goods in which these countries are going to remain competitive in related sectors, they are going to have to have competitive products and they will soon find themselves facing pressure to comport with most advanced producted.

And lastly, as these policies prove—or if I am correct, and the policies do fail, they are likely to turn to allies, other companies, in trying to pursue their own objectives.

And the allies that they turn to are unlikely to be the allies that have been forced on them. Twenty years ago, 10 years ago, Brazil pursued a development of technology in petrochemicals by aligning with France when the United States refused to provide—tried to force on it the technology policy.

I think that there is no reason not to expect that we will see the same thing now. That is, if we press too hard at this point, the French, the Japanese, the Koreans will be delighted to ally with these countries on a different basis.

The issue is, over the next generation of international technology competition that technology alliances between the United States and other countries will be critical. More than the direct competition of the Brazilians will be the character of the alliances that are formed.

In particular, the alliances now being formed between American technology firms and Korea will in my view pose less of a problem to American competitors than the Japanese. And in fact they are being understood as part of a strategy to try and block off the Japanese surge with technology transfer in alliance with Korean companies.

The fourth point that I would simply emphasize is that as we talk about the technology issues and focus on the American competitive position, we should not lose sight of the fact that access to foreign markets in Asia and access to foreign technologies, particularly in Japan, is the central issue.

And that in solving the debt crisis, we should—which must be done, I agree—we must not lose sight of where the long-term competitive interests of the United States actually lie.

Thank you.

Senator MATHIAS. Thank you very much for a very stimulating and thought-provoking statement.

You said we must tolerate policies. And I want to be absolutely sure what we are to tolerate.

Mr. ZYSMAN. The desires of Mexico and Brazil to exclude American producers except on a joint-venture basis, so that they can have a chance to try and develop their own technology base with their own indigenous companies.

At this point, as I say, I don't think those policies will be successful. And I think that therefore there will be a strong likelihood that they will turn away from them.

Senator MATHIAS. Wait them out, in other words, is your advice?

Mr. ZYSMAN. Yes.

Senator MATHIAS. Of course, that is not a very good political answer for those who are fighting the battles on a day-to-day political basis.

Mr. ZYSMAN. Well, for the companies who are fighting the battles on a day-to-day basis, the central issue in the Latin American market in particular is quite a secondary problem.

The central problem is in Asia and it is in the relationships with Korea. And I think that—in fact, in my view, pressure on Brazil is in some way diverting our attention from the kinds of strategy we should be adopting to open the Japanese market and assure that the kind of alliances that we need with Korea are solidly in place.

Senator MATHIAS. We are using resources of one kind or another to struggle with the Brazilian problems that ought to be concentrated on the Asian problem?

Mr. ZYSMAN. That is right. Let me emphasize the role of Korea in this. We have all watched the prices of color televisions come down, if you read the newspapers, and video tape recorders.

Senator MATHIAS. It has almost reached the point that I may buy one.

Mr. ZYSMAN. That is right, there you are. And in fact, the reason that those prices dropped is that the Japanese have now faced Korean competition. And in a sense, the Koreans are eating up the Japanese profit in consumer electronics, which is the greatest relief I think in the long run for American electronics firms.

The question is to assure the Korean case, not the Latin American case, that American firms—there is a real issue. At the moment there is no problem, but there is something——

Senator MATHIAS. You raised the question of Korea. Let me put to you the observations of one member of the Dole Mission which visited the Far East to look at trade problems during recent months.

And that was that if we in any way lean on Korea economically, commercially, Korea will then react on the security side by either demanding that we give them some offset payments for their defense expenditures or reduce their defense effort.

How do you react to looking at this kind of a comprehensive ballgame?

Mr. ZYSMAN. There are two issues. One is whether we should lean on Korea to limit their exports into the United States, thereby exacerbating their internal economic problems. That is one discussion. I am not in a sense in this set of comments focusing on that.

What I am really focusing on is assuring that American firms have appropriate kinds of opportunities for establishing satisfactory ventures with Japanese firms—or, sorry, with Korean firms.

Let me take a single instance. The Intel Corp. has recently transferred technology—256K Rem technology to the Koreans.

Very simply, the understanding is that as the Koreans manufacture those products, they will be taking away Japanese sales again. The question is, do those arrangements assure that American firms can participate satisfactorily in the profits from those joint ventures.

It is a different—I think that one can put pressures specifically in that area without necessarily having to put it on in the restriction of exports from Korean, which poses the other set of problems which you have raised.

In the long run, I think satisfactory joint ventures and licensing arrangements will be critical to our long-term economic relationships with Korea more than just the buying of exports.

Senator MATHIAS. Now, you have raised a very provocative question as to whether we should not simply move offshore with existing industrial processes. That if you just go offshore and look for cheaper labor, you are kidding yourself. Is that your point?

Mr. ZYSMAN. Yes, that is right. We then do not innovate in manufacture which permits us in some cases to keep portions of the production here.

Senator **Mathias**. And that in the long run, the American economy would be better served to stay home and find ways to be more productive.

Mr. **Zysman**. That is right. In some cases, that may require assistance from Government.

Senator **Mathias**. In almost all cases, it would require substantial capital.

Mr. **Zysman**. Yes, absolutely. In some cases, firms such as Motorola made the judgment that, at least for now, the capital is too expensive and that the short run is to import. That they shouldn't worry about the longer run issue.

In some cases, you know, some of the firms—not in this case, not Motorola but other firms—are thinking not only about moving their manufacturing processes offshore, but are specifically thinking about the fact that you have to have research and development facilities near your manufacturing so that therefore they should move substantial portions of the whole thing offshore.

And largely, again, the issue is the fear that they won't be able to compete from an American base. The only alternative to that is substantial manufacturing innovation. And that becomes a matter of national priority.

Senator **Mathias**. What do you do to the company to which you transfer a technology that is already obsolete at the time of transfer?

Mr. **Zysman**. Well, the question isn't simply—the technology may not be obsolete. Let me take the case of color television in which American firms did move offshore, bringing them current technology.

The problem was they failed to innovate in the manufacturing process, while the Japanese did. And soon it was no longer a matter of wage differentials, but of absolute production differential.

Senator **Mathias**. Well, by obsolete technology, I meant the process, the——

Mr. **Zysman**. Yes.

Senator **Mathias**. The whole process. Some years ago, Sri Lanka, which was suffering enormous economic difficulties, received a textile plant as a gift from the Peoples' Republic of China.

It was not a textile plant which was of the latest design and model. It didn't represent the most efficient, modern method of manufacture. It was presented with motivations other than those with which American corporations normally go offshore.

But what does that do to the Sri Lankans, putting them into the textile business?

Mr. **Zysman**. Let me emphasize and answer the question from the opposite angle. Which is that without a substantial advantage in manufacturing processes, the United States will be forced to compete with the Chinas and Sri Lankas on wages and that we therefore—that is why I emphasize this in dealing with this issue—have to assure that we have that manufacturing capacity to stay in portions of those sectors.

Or we can transfer technology and allow countries to adopt them as best they can. But if we simply concern ourselves only with the question of whether these countries get obsolete technology—I hope that technology we have in production for the next generation will be substantially in advance of the rest of the world.

At the moment, it is not. In fact, the Japanese are somewhat ahead in the area. And that is a serious part of our problem.

Senator **Mathias**. Peter, do you have any comments?

Mr. **Jones**. Yes, John and I respectfully disagree with each other on this one.

The one analogy we started to discuss that I think is relevant here is New England and the South. In the early history of the United States, all manufacturing was in New England at one time. And the South was an underdeveloped low-wage country.

Senator **Mathias**. No-wage country.

Mr. **Jones**. Well said. A long time before 1865 that is absolutely true. It was a no-wage country.

I can imagine that the same—essentially the same speech and comments that John Zysman just made about American industry moving to the southern part of the Western Hemisphere was made time and again when some of New England industry began to move into the South.

It does require creative destructiveness and change to do that. But if you look at New England today, two things have happened. One is we did keep our powder dry—John Zysman's strategy for staying ahead—innovation, new processes, new industry—but we also created a market in the South into which New England now sells and exports a great deal.

And we have got a larger economy in our common market for the whole country. And it seems to me that the same thing has got to work between the United States with the other industrial nations of the north and the third world of the south or we will blow ourselves up.

Senator **Mathias**. My only problem with that is, from my limited observation, it was not so much that we innovated—that New England industry innovated, as it was that replacements were found for it.

Mr. **Jones**. Yes.

Senator **Mathias**. I think, for example, just to give one example, there was a company called the Byron Leather Tannery which was located in Massachusetts. And somewhere around the end of the last century, they moved to Williamsport, MD, lock, stock, and barrel. That was presumed to be moving South in those days. And it has now since moved on from Maryland.

But they were not replaced by a more efficient leather company in Massachusetts.

Mr. **Jones**. No.

Senator **Mathias**. Presumably those workers went into other operations.

Mr. **Jones**. By innovation, I don't mean necessarily simply innovate within that industry, but you innovate to create new industries. And that has in fact happened. And the fact that there is a larger market in the South with which New England can work and invest and export has been a basis for New England's renovation.

There is lower unemployment in the State of Massachusetts today than in almost any State in the country. So the policy there seems, over time, to have worked reasonably well.

Albert, do you have any——

Mr. **Fishlow**. I think there is two considerations that are important. One is simply orders of magnitude. We are, after all, talking about these countries being relatively small proportions of total manufacturing.

In that sense, I think one should not exaggerate even the role of a Korea in terms of total world production.

The second observation is that a great deal of the problem that we seem to be facing in terms of innovation, in terms of the capacity of the American manufacturing sector, is really associated with the overvalued exchange rate since the early 1980's.

It is really part of our own problem of lack of adjustment in the U.S. economy, rather than what is going on in the rest of the world.

I think the great danger with focusing on the rest of the world in this is that it really distractes attention from what we can do ourselves in improving the situation.

Mr. **Zysman**. May I make one remark?

Senator **Mathias**. You have the floor for rebuttal.

Mr. **Zysman**. Thank you. It is not even rebuttal. I agree substantially with what both Peter and Al say. And then would still say that after all those remarks were made, there is still this piece of the problem that lurks there.

As we talk about who sells what to whom, as we import textiles or production from the Third World, we are exporting much of the production machinery.

Part of the long-run problem that I am emphasizing is that America in many cases has now lost its competitive position in the machinery and in the equipment. And it is not obvious to me that if there is a growing textile industry—in let's take in this instance, in one of the Third World countries, that they would not turn to German or Swiss equipment at this point even if they are exporting some of this back toward us.

It is not a disagreement with Al or Peter, as much of what they say is certainly true. But that if we don't deal domestically—and I agree with Al with this set of problems and our real increasing loss of manufacturing competitiveness, then in fact these other issues will simply not lead to a change in our south relations, but lead to a shift in America's position relative to the other advanced countries.

Mr. **Fishlow**. I agree with that, too.

Mr. **Zysman**. Thank you very much.

Senator **Mathias**. Thank you very much. We appreciate your making the effort to be here, notwithstanding the extraordinary conditions. At least I hope they are extraordinary conditions.

Mr. **Jones**. Yes, they are.

Mr. **Zysman**. I appreciate your taking the time to listen.

Senator **Mathias**. Peter, did you want to say something further on this topic?

STATEMENT OF PETER T. JONES, GRADUATE SCHOOL OF BUSINESS ADMINISTRATION, UNIVERSITY OF CALIFORNIA, BERKELEY

Mr. JONES. Yes, sir, I did.

I have one other main theme of my own testimony this morning which will reassure John, at least in the short run. It is that foreign direct investment isn't going to go in any significant quantity to the debtor nations in the next 3 to 5 years anyway because conditions generally are too risky. So you can rest easy for the next 3 to 5 years.

The essence of that part of my written testimony is that there has been a moveable feast from members of the administration as to how to solve this problem of the debtor developing nations.

They started telling us exports back here would do it. And then suddenly Motley, the Assistant Secretary for Latin America, said well, that isn't going to happen anymore, you can't count on exports to the United States continuing to increase at these rates.

Then they said, but we will help you get creditworthy through austerity, and then the banks will do more voluntary lending and that will solve it. And they tried that for 2 or 3 years and now everybody is saying that isn't doing it.

And as the export and voluntary lending doors closed on these folks, the next speech that came out of some of the administration was well, the real answer to all this is foreign direct investment. You can't do it all by exports, you can't do it all by voluntary lending by the banks. But now, if these countries will simply open their doors, change their regulations and encourage foreign direct investment, that will solve this problem in the next 3 or 4 years.

That isn't going to happen either. I will submit my full statement to you for the record about this—as to the fact of why between 1973 and 1981 foreign direct investment to the top 25 debtor developing countries grew at an average of 3.5 percent a year.

The base is somewhere between $5–10 billion a year, depending upon the particular year. Three percent of $5–10 billion is nothing. And in addition, the investment conditions over the next 5 years are very likely to be at least as bad as on average over the last 10. And, in fact, they may be worse over the next 5 years.

So any notion that there would be this sudden adequate surge of foreign direct investment in the short run is illusory.

That doesn't mean that the emphasis on getting investment and growth increased and hostility toward foreign direct investment eliminated in these countries isn't important to their own development over the medium- and longer-term. It is very important.

In terms of the importance of direct foreign investment to these debtor nations, I think there is one simple message for them. And that is, if they don't get with it on this matter of actively seeking more foreign and domestic investment, the world is going to pass them by.

As I have listened to American business leaders in the last few years, they are simply paying less and less attention to Latin America. There are so many other alternative and more attractive places for them to invest, including the fast growing Asian nations and the new Japans that are encouraging foreign direct investment.

Because of this some of my good friends in Latin America today including some of the industrialists there, are beginning to wake up and say, if we continue this attitude of hostility toward foreign investment, the world is simply going to ignore us—we are going to become more and more of a back water. And if we don't begin in Latin America to focus on these same issues of competitiveness, that the United States is beginning to focus on, we are simply going to be left behind.

So that is the message that I would offer to all our friends in Latin America that they have got to do two things. One, they have got to decide to end their hostility toward foreign direct investment. And two, they have got to rekindle growth so that they have an attractive investment climate.

Having said that, there is an equally important message to my colleagues in the American business community. And that is, we are not only part of the cure, we are very much part of the problem.

Over the last two generations, we have done enough to create part of this hostility by our lack of sufficient sensitivity to the host country needs. If we don't serve their own high development priorities as they define them—not as we define them—and do it in a way which is helping strengthen their private sector, if we don't do this, we create a lot of the hostility ourselves.

American business must wake up and realize that if we believe an aggressive, creative, innovative private sector in these countries is essential to their welfare and ours, there is only one way that we are going to help accomplish that, Senator. And that is, to strengthen the local private sector. Foreign private enterprise can't do it. Foreign private enterprise is de facto prohibited from playing any significant political role in these countries.

In fact, we are a target for people who oppose creative private enterprise. And we are not citizens of the country. Therefore, unless you have a vigorous, enlightened, supported, predominently local private sector in these countries, the forces of isolationism and nationalism and statism will continue to grow. And that in the long run will redound to the detriment of both the host country and the United States.

And my final point is that U.S. foreign direct investment in fact, as we began to discuss with John Zysman, is good for the United States and our own need to strengthen our international competitiveness in the world.

Foreign direct investment and U.S. exports go together. When we have overseas investment, the ties between the United States and those countries open up markets for American investment and American exports and American jobs in ways that simply wouldn't occur if we weren't there.

And so there is a vital U.S. national interest in U.S. private direct investment in Latin America. Orville Freeman commissioned a study a couple of years ago by Business International that shows that the large American companies who are above average in their foreign direct investment are above average in their job creation at home as well, and in their generation of American exports.

And Cordell Hull, who is going to join us later today, has given me some statistics that Bechtel has produced on what happens to American exports when American foreign direct investment takes place overseas and when Bechtel does construction jobs for American companies overseas.

The amount of U.S. exports and jobs it generates is very substantial. So it is good for the developing countries and for the United States. One last point on the developing countries need for more foreign direct investment.

When I lived down in Latin America for 7 years, many people were against foreign direct investment because they said it gave permanent ownership by foreigners to pieces of their economy.

And so many countries shifted to debt. They thought debt was preferable. Well, we have just learned in the last 5 years the problems that are created with debt, and that is you have contracted to pay whether your economy is in recession or not. And you have contracted to pay whether you have foreign exchange reserves with which to pay or nor.

In contrast, equity investment from abroad is self-adjusting. It is automatically adjusting. When an economy is in recession, there are no profits and nobody is trying to repatriate dividends, and there is no ongoing debt obligation to send scarce or nonexistent foreign exchange out of the country.

Therefore, foreign direct investment has its major benefits. Particularly if it is on a joint venture basis so that we are transferring technology and management know-how to our local private sector colleagues, it has many advantages that I think our Latin friends are beginning to wake up to.

But we must also mend our own ways in the U.S. business community in order to facilitate that process by responding to Latin America's own development priorities as they define them.

Senator **MATHIAS**. Do you have anything to add, Professor Fishlow?

Mr. **FISHLOW**. Well, I think that the only point that is worth adding is the effect of the debt crisis in Latin America in particular has been to destroy the myth that the state could do everything.

It has been the public sector that was borrowing and one of the salutory consequences of the debt crisis is a new attitude toward the private sector in these countries.

The danger is pushing it too far and too fast.

Senator **MATHIAS**. Really, it comes down to the fact that foreign direct investment as a remedy for our problems is, No. 1, inadequate.

Mr. **JONES**. Right.

Senator **MATHIAS**. Hopelessly inadequate, really. So we ought not to delude anyone that we should lean in that direction. It is from our domestic point of view avoiding solutions rather than finding solutions.

Mr. **JONES**. But it is not creating problems, serious problems. It can be good for us, as long as we are tackling also our own problems of competitiveness here at home.

Senator **MATHIAS**. But if you are not, if you are just using it as a means of looking for a method of lower price production, then you are simply avoiding solutions rather than finding them.

Mr. **JONES**. Correct.

Senator **MATHIAS**. And that if we are simply moving noncompetitive techniques offshore, then we are not meeting the local high technology priorities of the new locations.

If you can avoid those difficulties, then you have a different picture.

Mr. **JONES**. May I say, in conclusion that we must change our ways of dealing in these countries so that we are doing more on a joint venture basis to strengthen the local private sector. Because without a local strong private sector, foreign direct investment is severely handicapped.

Senator **MATHIAS**. Well, I think with that statement perhaps we should move to the next panel.

Mr. **JONES**. Good.

Senator **MATHIAS**. Our next panel then will deal with the questions of "Credit Flows to the Private Banking System."

Mr. **JONES**. Bob Heller, Bob Wesson, and Cordell Hull.

Senator **MATHIAS**. Mr. Wesson, Dr. Heller, and Mr. Hull. Gentlemen, in which order do you wish to appear?

Mr. **JONES**. Bob Heller first, and then Bob Wesson and then Cordell Hull.

Senator **MATHIAS**. Dr. Heller, we will start with you then.

STATEMENT OF H. ROBERT HELLER, DIRECTOR OF INTERNATIONAL ECONOMIC RESEARCH, BANK OF AMERICA

Mr. **HELLER**. Thank you very much, Mr. Chairman. I am very pleased to testify on the outlook for credit flows through the private banking system to the developing countries.

There are three aspects of this issue. First of all, what are the condition in the industrialized countries, as well as the developing countries, as far as the framework or the economic environment for international capital flows is concerned.

Second, what is the changing role of commercial banks that is being played in that particular process. And, third, how can the international organizations like the World Bank and the IMF assist further bank lending to the developing countries.

International capital flow clearly cannot be analyzed and understood in isolation. They must be seen within the larger economic and financial framework. That is an issue that we covered very much at yesterday's testimony and therefore I will skip over those aspects of my prepared statement.

Turning to the commercial banks and the role of commercial banks in the financial flows to developing countries, I think not only the external environment has changed that commercial banks are operating in, but so have the institutions themselves that are active in the international arena.

That is particularly true of the large commercial banks that are active in international lending. These banks no longer start with a clean slate, but they have to take account of the cumulative effect that past actions have had on their balance sheets and their earnings.

The capacity of these banks to engage in new international lending cannot be analyzed in isolation but must be seen within the framework of the existing asset and liability structures and the earnings capacities of these institutions.

In addition, the regulatory and legislative actions that have been taken in recent years will have an enduring impact on the willingness of banks to engage in further international lending.

Not only the environment has changed, but so have the rules of the game and the conditions of the players.

I think if one is to assess the outlook for further international lending by commercial banks to developing countries, one has to answer three questions.

One, what is the likelihood that banks already active in the international lending arena will increase the proportion of their portfolio devoted to international assets.

Two, what is the likely overall growth of commercial banks. And, three, what is the likelihood that new banks will enter the international lending business.

Are international banks likely to increase their foreign assets faster than their domestic assets? The answer to that question is, probably no. In 1970, the worldwide crossborder exposure of banks to foreign borrowers amounted to only $54 billion. By March 1985, this exposure had grown to $740 billion.

In many major banks the international loan portfolio now accounts for half of the total assets, and it is difficult to find large American banks that are aggressively expanding their international asset portfolio.

The reasons for this reluctance are many-fold. One, many banks simply do not regard it as prudent to place more than half of their total assets abroad.

Two, at the present time, the economic and political environment abroad is not as attractive as it is in the United States, and most of the expansion of American banks has therefore taken place domestically.

Furthermore, the outlook for many of the commodities and industries that form the basis of the economic activity in the developing countries is not very promising at the present time. Renewed political and social unrest in many regions of the world adds another source of uncertainty.

Three, bank profit opportunities abroad are not very good at the present time either. There seem to be two groups of countries in the world these days. In the first group, which comprises many of the heavily indebted countries, private sector loan losses are unacceptably high. Many sovereign loans have to be rescheduled.

In the other countries such as Europe, Japan, and the better credit risks in the developing world, lending margins are exceedingly thin. And it is therefore difficult to obtain adequate rates of return on capital. This problem is exacerbated by the insistence of the regulators upon ever higher capital-to-asset ratios.

Consequently, many American banks have closed their foreign branches or reduced their numbers, signaling a permanent deemphasis on foreign lending. This has been true for branches in the developing countries as well as offices in the major money centers.

The overall growth rate of commercial bank assets is also likely to be modest. The regulators keep insisting on ever higher capital asset ratios for commercial banks.

After asking the banks for almost a doubling of the capital asset ratios during the last 3 years, new demands are now being heard for a further 50 percent increase in the capital-to-asset ratios. There are only two ways in which banks can comply with this regulatory mandate, raise more capital or reduce asset growth.

Raising capital is clearly a difficult procedure for many banks under current conditions where bank stocks are selling at or below book market value. Consequently, banks have curtailed their asset growth.

They have done so by selling loans to other investors and by deemphasizing those areas of business that will not generate new assets on their balance sheets. Clearly, loans to developing countries are among the targets for reduction.

Legislative and regulatory obstacles continue to constrain the growth of commercial banking system in the United States, as well. Years of debate have yet to produce comprehensive Federal legislation on interstate banking.

The continued uncertainty makes investors wary of committing substantial financial resources to banking. All this has the effect of retarding the overall growth of the banking system.

I believe that nationwide banking would permit a consolidation of the banking system that would result in better diversified institutions. By consolidating small banks that now focus exclusively on domestic business with banks that are already active internationally, the ratio of foreign to domestic assets on their books would decline.

And it stands to reason that these enlarged and better diversified banks would also find it prudent to engage in some additional international lending. Interstate banking would therefore help to bring about an increase in the total volume of financial flow to developing countries.

In the absence of such a consolidation, it is unlikely that a significant number of new American banks will enter the international lending field.

Turning to the international organizations and commercial bank lending, I think there has been a traditional reluctance on behalf of the IMF and the World Bank to engage in direct cooperation with commercial banks.

In view of the seriousness of the situation facing us now, it is promising that a greater measure of cooperation has been observed in recent years. It is important to foster this process in the future so that the international organizations and the commercial banking system act increasingly in a mutually supporting and cooperative fashion.

The International Monetary Fund has been most helpful in the last 3 years in assuring adherence to financially prudent policies on behalf of the debtor countries.

By helping in the design and implementation of financial and economic adjustment programs, the Fund has helped to prevent a further erosion of the international financial environment, and has also helped to lay the foundation for the resumption of sound economic growth.

Economic growth will increase the debt service capacity of the debtor countries, and thereby open the door to a resumption of international credit flows. I think especially the World Bank has an important role to play in that process.

For those countries where ongoing adjustment policies have to be supported by further balance of payments financing, the IMF should provide the necessary funds. That is the proper role of the institution as stated in its charter.

It is generally recognized that there is a need to provide new trade financing for imports by the developing countries. Imports are needed for essential raw materials, equipment, spare parts and so on, to get the production process rolling again.

Given the reluctance of commercial banks to make new credit facilities available to countries that are already unable to service their existing debt, there is an urgent need for an innovative approach to this problem.

The IMF or the World Bank could implement a new "Trade Finance Facility" which would provide discounting facilities or guarantees to commercial banks that commit new money for international trade financing.

Such a facility could be available only to countries undertaking appropriate adjustment measures, and only new bank loans would be eligible, thus negating the charge that a bailout for the banks is involved.

The new international investment guarantee agency was recently approved by the Board of Governors of the World Bank in Seoul. It will also be most helpful in rejuvenating international capital flows to the developing countries.

But, clearly, there is no quick-fix solution to the international debt problem. It took several years to build up the excessive debt levels, and it will take several years to reduce them.

As I have stated, the following actions would be helpful in furthering that process.

One, the developing countries need to persevere in their adjustment efforts and restore their own creditworthiness. That is a precondition to any new voluntary lending through the private banking system or international capital markets.

Two, the regulatory and supervisory authorities should keep capital and regulatory barriers within reasonable bounds. Currently they inhibit new international lending by commercial banks.

Federal legislation permitting interstate banking would result in a strengthening of the banking system in the United States and result in an increase in the total volume of international lending.

Three, the IMF should make new balance of payments financing available where this is necessary to implement adjustment programs.

Four, the IMF or the World Bank should establish a trade financing facility that would provide guarantees or discount facilities to banks that make new trade finance available to the debtor countries.

And, finally, the World Bank should press ahead with the ratification and swift implementation of the MIGA.

Thank you very much, Mr. Chairman.

Senator **Mathias**. Thank you very much.

[Mr. Heller's prepared statement follows:]

PREPARED STATEMENT OF H. ROBERT HELLER

Mr. Chairman, it is a pleasure to testify on the outlook for credit flows through the private banking system to the developing countries. I would like to concentrate on three aspects of the issue: First, I will focus on the evolving pattern of international capital flows from a global perspective. Second, I will look at the changing role played by commercial banks in that process. Third, I will make some observations regarding the ways in which the International Monetary Fund and the World Bank could assist in furthering new bank lending to the debtor nations. As requested by the Committee, I will outline the policies and practices necessary to achieve a satisfactory outcome and include my recommendations for action.

1. The Evolving Pattern of International Capital Flows

International capital flows cannot be analyzed and understood in isolation. They must be seen within the larger economic and financial environment. I covered many of the salient issues in yesterday's testimony on the economic policies in the industrialized countries that would contribute to an easing of the international debt service problems and help to

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foster new economic growth. The capital flows to the developing countries that can be expected to occur in the coming years will depend to an important extent on the economic policies pursued by the industrial countries.

International capital flows are very much like fluids that can run through a system of channels connecting the surrounding economies. As conditions in the environment change, the financial flows will respond accordingly. But it is also true that these fluids will select the path of least resistance -- so as to accomplish the task at minimal expense and effort. There are limits to the capacity of any one of these channels to carry additional loads, and the flows will react to obstacles or impediments placed in their path.

Much of the decade of the 1970's was characterized by the large current account surpluses of the oil-exporting countries and corresponding deficits by the non-oil developing countries. In the absence of major alternative financial channels, this task of matching willing lenders with willing borrowers was performed by the international commercial banking system. Because very little of the financial flows to the non-oil developing countries took the form of direct foreign investment, the bulk of the funds passed through the credit market. As a result, the external debt of the non-oil LDCs increased by about $425 billion in the 1974-81 period.

Higher interest rates in 1980-82 and the accompanying world recession resulted in lower commodity prices and falling export volumes for many developing countries. Countries that were already in a weakened financial position or that failed to take swift adjustment measures found it increasingly difficult to service their external debt. Those countries that found their debt burden excessive and had to disrupt their debt service payments learned that sources of voluntary private lending dried up quickly. The pattern of current account imbalances changed drastically in 1982. Since then, the oil-exporting countries have maintained rough balance in their current accounts. Thus, they have been eliminated as a major source of international capital flows.

Instead, Japan and some of the European countries began to run large current account surpluses. At the same time, the United States emerged as a major current account deficit country. In the next few years, the U.S. will absorb the entire current account surplus of the other large industrialized nations. Unless the United States borrows less or the other industrialized nations make more external savings available, there will be simply no funds left for the developing countries to borrow.

In other words, while international capital used to flow from the oil-exporting to the oil-importing developing countries, it now flows from the other industrialized countries to the United States.

It will take major economic policy adjustments in both the industrial countries and the developing countries to set the stage for a resumption of capital flows to the LDCs. The requisite policies of the industrial countries were discussed in detail at yesterday's hearings. In particular, the need for Japan to import more and for the United States to reduce her budget deficits was stressed.

Complementary policy measures have to be implemented by the developing countries themselves. Reduced regulatory controls and taxation of business, a removal of barriers to domestic and foreign direct investment, a reduction of the state bureaucracy, the privatization of governmental and parastatal enterprises, the elimination of subsidies, and similar measures designed to provide new incentives to entrepreneurs are called for.

Providing greater economic freedom in the developing countries will invigorate economic growth, as the examples provided by many free-trade oriented developing countries have shown. Such market-opening measures will also be conducive to a resumption of international capital flows to the developing countries.

2. The Changing Role of Commercial Banks

Not only the external environment has changed, but so have the financial institutions active in the international arena. This is particularly true of the commercial banks that are major international lenders. These banks are no longer starting with a clean slate, but have to take account of the cumulative effect that past actions have had on their balance sheets and their earnings. The capacity of banks to engage in new international lending cannot be analyzed in isolation, but must be examined within the framework of the existing asset and liability structures and the earnings capacities of the banks.

In addition, regulatory and legislative actions have been taken in recent years that will have an enduring impact on the willingness of banks to engage in further international lending. Not only the environment has changed, but so have the rules of the game and the conditions of the players.

If one is to assess the outlook for further international lending by commercial banks to developing countries, one has to answer three questions: one, what is the likelihood that banks already active in international lending will increase the proportion of their portfolio devoted to international assets? Two, what is the likely overall growth rate of commercial banks? Three, what is the likelihood that new banks will enter the international lending business?

Are international banks likely to increase their foreign assets faster than their domestic assets? The answer to that question is, probably no. In 1970, the world-wide cross-border exposure of banks to foreign borrowers (excluding other banks) amounted to only $54 billion. By March 1985, this exposure had grown to $740 billion. In many major banks the international loan portfolio now accounts for half of the total assets, and it is difficult to find large American banks that are aggressively expanding their international asset portfolio. Their inclination to do so is smallest in the already heavily indebted developing countries.

The reasons for this reluctance are manyfold: One, many bankers simply do not regard it as prudent to place more than half of their total assets abroad. That limit has been reached in many U.S. money center banks. for many foreign banks the problem is compounded by the high value of the dollar, which has inflated the dollar-denominated portion of their balance sheet.

Two, at the present time, the economic and political environment abroad is not as attractive as it is in the United States, and most of the expansion of American banks has therefore taken place domestically. Furthermore, the outlook for many of the commodities and industries that form the basis of economic activity in the developing countries is not very promising. Renewed political and social unrest in many regions of the world adds another source of uncertainty.

Three, profit opportunities abroad are not very good at the present time. There seem to be two groups of countries: in the first group, which comprises many of the heavily indebted developing countries, private sector loan losses are unacceptably high. Many sovereign loans have to be rescheduled. In the other countries, such as Europe, Japan, and the better credit risks among the developing countries, lending margins are exceedingly thin and it is therefore difficult to obtain adequate rates of return on capital. This problem is exacerbated by the insistence of the regulators upon ever higher capital-to-asset ratios.

Consequently, many American banks have closed their foreign branches or reduced their number, signaling a permanent deemphasis of foreign lending. This has been true for branches in the developing countries, as well as offices in the major money centers.

The overall growth rate of commercial bank assets is also likely to be modest. The regulators keep insisting on ever higher capital asset ratios for commercial banks. After asking the banks for an almost doubling of the capital asset ratios during the last three years, new demands are now being heard for a further 50 percent increase in the capital-to-asset ratios. There are only two ways to comply with this regulatory mandate: raise more capital or reduce asset growth.

Raising capital is a difficult procedure for many banks as long as their stocks are selling at below book-value. Credit ratings of many banks have suffered in recent years, further increasing the cost of raising new capital. At the same time, accounting conventions prevent banks from recognizing the increased value of their property. It is no accident that several banks have found it advantageous to sell buildings that have appreciated in value, so that their capital base will properly reflect the value of their holdings.

Banks have also curtailed their asset growth. They have done so by selling loans to other investors and by emphasizing those areas of business that will not generate new assets on their balance sheets. A greater reliance on service charges and fee generating activities has been a natural consequence of the pressure to increase capital-to-asset ratios.

Legislative and regulatory obstacles continue to constrain the growth of the commercial banking system in the United States. Years of debate have yet to produce comprehensive federal legislation on interstate banking. Interstate banking is coming to the United States in a piecemeal fashion. The continued uncertainty makes investors wary of committing substantial new financial resources to banking. All this has the effect of retarding the overall growth of the banking system.

Nationwide banking would permit a consolidation of the banking system that would result in better diversified institutions. These truly national banks would be better equipped to face the structural changes now taking place in the American economy and to channel financial resources to the best possible use. By consolidating small banks that now focus exclusively on domestic business with banks that are already active internationally, the ratio of foreign to domestic assets would decline for these institutions. It stands to reason that these enlarged and better diversified banks would then also find it prudent to engage in some additional international lending. Interstate banking would therefore help to bring about an increase in the total volume of financial flows to developing countries. In the absence of such a consolidation, it is unlikely that a significant number of new American banks will enter the international lending field.

The increasing reliance by borrowers on direct security placements to obtain the needed capital is a natural outgrowth of the more limited role played by commercial banks. In many instances, the credit ratings of banks themselves have slipped, and the safety provided by banks may therefore also have deteriorated in the eyes of investors. Consequently, the cost of attracting funds has increased for the banks, and by this their competitive advantage in financial markets has been eroded.

The tendency for borrowers to tap international financial markets directly goes hand in hand with the reluctance of commercial banks to increase their asset portfolio. For international borrowers, including those from developing countries, this implies that they have to make a greater effort to borrow directly in international capital markets. To be successful in this endeavor, their credit quality must be beyond question. Developing countries are therefore well advised to enhance their credit quality so that they will be able to tap international financial markets directly.

3. International Organizations and Commercial Lending

There has been a traditional reluctance on behalf of the International Monetary Fund and the World Bank to engage in direct cooperation with commercial banks. In view of the seriousness of the situation, it is promising that a greater measure of cooperation has been observed in recent years. It is important to foster this process in the future, so that the international organizations and the commercial banking system act increasingly in a mutually supportive and cooperative fashion.

The International Monetary Fund has been most helpful in the last three years in assuring adherence to financially prudent policies on behalf of the debtor countries. By helping in the design and implementation of financial and economic adjustment programs, the Fund has helped to prevent a further erosion of the international financial environment and has helped to lay the foundation for a resumption of sound economic growth. Economic growth will increase the debt service capacity of the debtor nations and thereby open the door to a resumption of international credit flows. The process of "enhanced surveillance," which provides for frequent consultations with the IMF, is essential to maintain the confidence of international creditors.

For those countries where ongoing adjustment policies have to be supported by further balance of payments financing, the IMF should provide the necessary funds. This is the proper role of the IMF as stated in its Charter.

It is generally recognized that there is a need to provide new trade financing for imports by the debtor nations. Imports are needed for essential raw materials, equipment, and spare parts to get the production process rolling again. Given the reluctance of commercial banks to make new credit facilities available to countries that are already unable to service their existing debt, there is an urgent need for an innovative approach to the problem.

I have suggested elsewhere that the IMF or the World Bank should implement a new "Trade Finance Facility," which would provide discounting facilities or guarantees to commercial banks that commit new money for trade financing. Such a facility would be available only to countries undertaking appropriate adjustment measures, and only new bank loans would be eligible -- thus negating the charge that a "bail-out" for banks is involved.

The new International Investment Guarantee Agency recently approved by the Executive Directors of the World Bank to be ratified this week at the annual meetings of the World Bank in Seoul will also be most helpful in rejuvenating international capital flows to the developing countries.

4. Recommendations for Actions

There is no one quick-fix solution to the international debt problem. It took several years to build up the excessive debt levels, and it will take several years to reduce them to manageable proportions. As I have stated, the following actions would be helpful in furthering that process:

One, the developing countries need to persevere in their adjustment efforts, and restore their own creditworthiness. This is a precondition to any new voluntary lending through the private banking system or international capital markets.

Two, the regulatory and supervisory authorities should reduce capital and regulatory barriers that currently inhibit new international lending by commercial banks. Federal legislation permitting interstate banking would result in a strengthening of the banking system in the U.S. and result in an increase in the total volume of international lending.

Three, the IMF should make new balance of payments financing available where this is necessary to implement approved adjustment programs.

Four, the IMF or the World Bank should establish a Trade Financing Facility that would provide guarantees or discount facilities to banks that make new trade finance available to the debtor nations.

Five, the World Bank should press ahead with the ratification and swift implementation of the Multilateral Investment Guarantee Agency.

Mr. Wesson.

STATEMENT OF ROBERT WESSON, HOOVER INSTITUTION

Mr. **Wesson**. My name is Robert Wesson, and I am a senior research fellow at the Hoover Institution. And I am not an economist, I am a little bit out of my area here. I am a political scientist interested in Latin America and Latin Americans.

Senator **Mathias**. That puts us very nearly on the same wave length, although you are still ahead of me. Because I can't claim to be either an economist or a political scientist.

Mr. **Wesson**. I have taken an interest in the debt question for the last several years because it has seemed to be the big thing hanging over Latin America, the problem putting everything else in the shade.

Consequently, I have looked into it a bit and tried to think about it and see what I might come up with in regard to ideas and suggestions. And I have a few specific policy ideas which I would like to put forward in hopes that they may be considered.

First, I would like to say in regard to what Peter Jones was saying just a few minutes ago, that there is no solution is one of the most obvious things. There is no way to simply say, well, let these countries do something and then the money will start to flow. But it has to be pushed very much.

Incidentally, along that line I would like to make a little negative remark, that someone said that when there is a debt that it has to be paid. Well, maybe it should be paid but it doesn't have to be paid. And debts frequently are not paid.

And I strongly suspect that most of Latin American debts are not going to be paid. There are a number of countries that are not engaged in making payments recently, and it looks like the number is going to grow.

The only real incentive for continuing to make payments is the prospect of getting more loans, of course.

Senator **Mathias**. The chairman of the board of City Corp, as I recall, made a somewhat similar statement some years ago and caused a great stir in the world.

Mr. **Wesson**. I remember some chairman stating rather baldly that countries didn't go bankrupt. He hadn't read his history.

It is my feeling that there is no possibility for real recovery of the Latin American economy without a return to high levels of investment, both national and foreign, and also the repatriation of the enormous amounts of capital that has been sent abroad since 1981.

Now, this cannot be brought about in turn until the shadow of the debt problem is lifted and the whole question is brought under some kind of control in order to restore necessary confidence.

This inevitably will be a long and difficult process. But I think it should be possible to make a start quickly toward providing new capital while reducing the burden of debt service.

This could be done by permitting debtor nations to make payments in national currency at an equitable rate of exchange into a fund or funds held and managed by banks. This fund would be applied to new productive investments in the debtor country in agreement with the government concerned, and preferably in enterprises increasing the export capacity.

The idea has sometimes been mooted of having banks take over existing enterprises, particularly state corporations, in payments of debts. That is politically impossible and is not acceptable in the politics of the countries concerned.

But new investments, I would judge from my conversations with a good many Latin Americans, would generally be welcome and could be arranged.

Investments should be made in partnership with outside capital. Venture capital from the United States might be brought in. And also, of course, I suppose that shares in any such kind of funds would be for sale, and the equity would be remittable after an agreed period.

There would have to be some agreement that for a certain time money would not be taken out but there would be a stake which eventually should be subject to any kind of free treatment.

Such a procedure would be unconventional, but I though think it would be acceptable to banks because it would leave them with sounder assets than the current practice of financing more or less—usually more—of debt service payments by new loans.

Through an investment the banks would acquire control over the application of their assets. The assets would be changed from something on the paper with the signature of the borrower, to a particular ownership within the country which the banks could control. And it seems to be obvious that there would be better prospects for eventual recovery.

Conversion of as much as possible of the debt into new equity would also of course reduce the burden instead of increasing it, as present procedures do, and it would stimulate instead of depressing the economy.

There are a number of other possible programs that might supplement such an approach to the payment of the debt. For example, you might look to accepting national manufactures for part payment.

There are problems, of course, but it should be possible to find goods that could be bartered or sold in ways not competitive with U.S. exports. Incidentally, the Russians are more politically minded than the United States in this connection and have done that in connection with their debt with Peru.

It should also be possible to couple debt payments in various ways with trading arrangements among debtor countries and with the United States. One of the unhappy aspects of that problem is that countries are pushed to reduce imports, which means reducing imports from other debtor countries, which means a general depression of trade.

Incentives could be given within the framework of debt payments for increasing their imports from other countries of materials and requisites to help in their own economies and of course in their export capacity.

The question of access to the American market, of course, could be related more than it has been to the question of debt payment. And there could be rewards in terms of trade facilities for not only certain programs, but directly connected with the attention to the debt obligation.

Such schemes would obviously not be ideal for the banks. But I think the banks would recognize that the problem arose from miscalculations on all sides and also from unforeseen circumstances, and that a great deal of money has been lost and that equity as well as realism requires that the losses should be shared.

The banks have not taken that point of view. They have acted as though they have everything perfectly, which of course is unrealistic to a high degree and which tends to aggravate the situation and makes it more difficult to reach an equitable solution.

There has been a lot of talk of the crisis having been mastered since August 1982, by the numerous renegotiations or rollovers and new unsound loans to keep up payments on old unsound loans.

These have been accompanied by austerity programs designed to give an impression that the problem arises from bad policies of the debtors and that steps are being taken to make repayments possible, very few of which have had any real effect and none of which of course has come anywhere near solving the problem.

The overall result of all the measures of the last several years since August 1982 have been an increase in the amount owed by about 20 percent, the worst depression in Latin America in half a century, perhaps ever, and the weakening of the basic capacities of Latin American economies.

As the banks become less agreeable to extending new loans that obviously cannot be paid—Mr. Heller has pointed out reasons—the debtors become less willing to stretch themselves to make payments on old ones, both sides should acknowledge the obvious fact that the debtor nations are not going to be able to pay or be willing to pay in the sense of transferring large net amounts of capital out of their economy to the coffers of the creditors.

That is, the pretense that there is a liquidity problem should be abandoned and it should be recognized that there is a solvency problem.

The situation, I believe, should be approached in the same spirit as a domestic bankruptcy, with negotiations to determine what can be salvaged for the creditors, how things can be managed to help the debtors work out payments within their limited capacities and come to agreements for settlements less than ideal, which will permit and encourage economic recovery.

Moreover, the U.S. Government should cooperate strongly in the resolution of the debt problem. Since the Mexican earthquake, they have been shaken up and come to a recognition that something has to be done, as against the previous policy of closing eyes to it, frankly speaking.

The Government bears a moral responsibility for having encouraged reckless lending policies for reasons of short-term economic and political advantage. The Government also has a strong interest in the economic revival of these Latin American countries for the sake of exports, and an even stronger interest in stability, democracy and friendly relations with Latin America, all of which are seriously threatened.

Troubles in South America could make Central American problems seem trivial. The debt morass, finally, represents a major calamity for the debtors and it can become much worse and then turn into a political crisis, unless it is brought under control.

It should be possible in a spirit of compromise to reach reasonably statisfactory solutions, however, possibly even strengthening rather than disrupting commercial and political relations as the two sides get together to try to work out the best possible realistic arrangements, which do not mean merely postponement.

Thank you, sir.

[Mr. Wesson's prepared statement follows:]

PREPARED STATEMENT OF ROBERT WESSON

No real recovery of Latin American economies is possible without a return to high levels of investment, both national and foreign, and the repatriation of capital sent abroad since 1981. This is not to be expected until the foreign indebtedness afflicting all Latin American cuntries is brought under control.

This must be a long and difficult process. However, it should be possible to make a start immediately toward providing new capital while reducing the burden of debt service. This could be done by permitting debtor nations to make payments in national currency at an equitable rate of exchange into a fund or funds held and managed by the banks. This fund would be applied to new productive investments in the debtor country, in agreement with the government concerned. The idea sometimes mooted of banks taking over existing enterprises in payment of debts is not politically acceptable; new investments, however, would generally be welcome. They might be made in partnership with outside venture capital or be sold. Profits would be remittable after an agreed period.

Although unconventional, such a procedure should be acceptable to banks, because it would leave them with sounder assets than the current practice of financing more or less, usually more, of debt service payments by new loans. Through an investment the banks would acquire control over the application of their assets and have better prospects of eventual recovery. Conversion of as much as possible of the debt into new equity would also permit reduction of the debt burden instead of steadily increasing it, as current restructuring does, and would stimulate instead of depressing the economy.

Conversion of debt into equity in this fashion might be supplemented or accompanied by other programs. For example, arrangements could be made to accept national manufactures for part payment, goods that could be bartered or sold in ways not competitive with U.S. exports. Debt payments could also be coupled in various ways with trading arrangements among debtor countries and with the United States. Thus, facilities might be given for imports from debtor nations of materials needed for export production in other debtor nations.

Such schemes would not be ideal for banks. But it must be recognized that the problem arose from miscalculations on all sides and from unforeseen circumstances, that a great deal of money has in effect been lost, and that equity as well as realism requires that the losses be shared. Since August 1982 there has been much talk of the crisis having been mastered, if not solved, by the numerous renegotiations or roll-overs, and new unsound loans to keep up payments on old. These have been accompanied by "austerity programs," designed to give an impression that the problem arises from bad policies of the debtors and that steps are being taken to make repayments possible. But the result has been only an increase of the amount owed by about 20%, the worst depression in Latin America for half a century, and a weakening of the basic capacities of Latin American economies. Incidentally there has been a large reduction of U.S. exports.

As banks become less agreeable to extending new loans that obviously cannot be paid, and the debtors become less willing to stretch themselves to make payments on old ones, both sides should acknowledge the obvious fact that the debtor nations are not going to be able or willing to pay in the sense of transferring large net amounts of capital in dollars to the creditors. That is, the pretense that there is a liquidity problem should be dropped, in recognition that there is a solvency problem.

The situation should be approached in the same spirit as a domestic bankruptcy, with negotiations to determine what can be salvaged for the creditors, within the limited capacities of the debtors. The debtors and creditors alike have a strong interest in a settlement that will permit economic recovery.

The U.S. government should cooperate strongly in the resolution of the debt problem. It bears some moral responsibility for having encouraged feckless lending policies for reasons of short term economic and political advantage. The government also has an interest in the economic revival of Latin America for the sake of exports. It has an even stronger interest in stability, democracy, and friendly relations with Latin America, all of which are seriously threatened. Troubles in South America could make Central American problems seem trivial.

The debt morass represents a major calamity for the debtors, and it may become much worse and turn into a political crisis. It should be possible, however, in a spirit of compromise, to reach reasonably satisfactory solutions, perhaps even strengthening rather than disrupting commercial and political relations.

Robert Wesson
Hoover Institution

Senator MATHIAS. Thank you very much, Mr. Wesson.

Mr. Hull.

Mr. HULL. Thank you, Senator. I am here for a discussion, not to give a prepared statement. At least that is how I understood my assignment from Peter Jones.

Mr. JONES. Yes, that is right.

Senator MATHIAS. We will so employ you.

Mr. HULL. I think we have heard here maybe two contrasting views of the situation. One is that there is a fundamental insolvency in the debtor nations and that we need some bankruptcy remedies. The other is that we are really instead addressing only a liquidity situation which in due course can be resolved with proper extensions on repayment of credits coupled with perhaps some international assistance to help along that process.

I am speaking here as an individual, although I am executive vice president of Bechtel Power Corp. and drawing on my experiences from Bechtel and elsewhere. Based on that experience I believe that one of the fundamental economic vehicles of development in developing countries involves the creation of new major projects.

Please forgive me if I approach the issue primarily from that aspect, because that has been basically the basis of my experience. International projects bring much to a host country because they involve the import of machinery and engineering services from abroad, as well as the development of natural resources and, the export of commodities, raw materials or manufactured goods into the world economic stream. They are powerful vehicles of economic development and growth in various sectors, both in host countries and the exporting nations assisting in the development process.

Dr. Heller made a statement that the debt in developing countries is excessive now. I would like to suggest that it is excessive only in relationship to current worldwide economic activity and growth.

If we could change the fundamental base of world economic activity and growth in a substantive, positive way, that would bring the debt ratios and debt servicing problems more into line.

If we harken back to the 1950's and 1960's, by and large we found a favorable growth pattern for the development of major projects in the developing countries. Worldwide we had a stable and low rate of inflation. We had a stable fiscal policy in the United States by and large. We did not have large budget deficits in comparison to today. Also, we had stable currency exchange rates throughout the world.

In many host developing countries we had a more favorable environment toward private investment overseas. Worldwide we had a fairly good development program. Many of the international projects involved a partnership between a U.S. multinational or a foreign multinational corporation and, the host country in developing the country's resources.

As we moved into the 1970's, we saw less multinational development with private investors and more host country owner development undertaken. A pattern evolved where commercial banks preferred to lend to Government agencies and to Government-sponsored activities, as contrasted with lending to what you might call private and mixed-private/public ownership activities in developing nations.

This was understandable, because banks have to deal with the credit problem. However, in its essence, I think this worked to the disadvantage of privately-sponsored projects and market disciplines.

Then as we moved into the 80's, we saw the situation where there was a fundamental drying up in credits for projects in the less developed countries and regardless of the type of owner. This is where we are today.

I would suggest that Dr. Heller is on the right path when he suggested we are dealing with a liquidity as contrasted with an insolvency problem. Also, we need some new international vehicles which will help bring together capital from multinational corporations, be they United States, European, or Japanese, local private groups in host countries, and local government agencies as the World Bank. We need mechanisms to guarantee and assure financial institutions, such as private banks lending for these development activities and to foreign investors, that there will be sufficient economic stability in the world, sufficient host country receptivity and sufficient credit backing that we can have reasonable assurance of repatriation of investment capital and repayment of foreign debt.

To me the most important aspect in alleviating the current situation is to get economic growth going again in these countries and to find vehicles which will channel these combinations of resources both internally and externally into new development patterns and projects.

Again while I believe Dr. Heller, that the things that you outlined are correct. I would only question if they are sufficient measures to alleviate the problem.

Senator **Mathias**. Thank you very much, Mr. Hull.

Professor Fishlow, do you want to comment particularly on the liquidity and insolvency side of this issue?

Mr. **Fishlow**. I think what it comes down to is a theme that we have seen come up many times before, Senator. It is a question of sequencing.

I think those who see it as a liquidity problem tend to argue that, with a little bit of additional money, you will create economic growth which will then generate large international credit flows.

Those who see it as a solvency problem are really saying you need larger international credit flows in order to create the economic growth.

And I think the liquidity-solvency distinction really isn't helpful, as opposed to getting down to the policy issue of how much money is in fact necessary now to begin with.

Senator **Mathias**. When you said it was a sequencing problem you had me worried. You run out of cash before you go bankrupt. Peter?

Mr. **Jones**. One thing that I would like to do. The retired vice chairman of the Bank of America, Bill Bolin, was going to be with us today to testify but he is in surgery.

Therefore, I have his statement, and I would simply like to submit the full written statement for the record.

[Mr. Bolin's prepared statement follows:]

PREPARED STATEMENT OF WILLIAM H. BOLIN

LDC FINANCE: WHAT NEXT?

I. THE REAL PROBLEM

Satisfactory long-term economic growth in the industrialized countries is not possible without positive per capita growth in the underdeveloped world. This reality is now challenged by very few economists. However, it is accepted by remarkably few political leaders in the rich nations.

Even smaller numbers of leaders articulate to their followers that growth in many rapidly developing countries depends heavily upon continuous transfers of resources from the richer societies by means of investment or credit. The need existed long before the recent crisis and is accelerating again, as the extraordinary contraction of LDC economies is reversed and production picks up speed. It is possible now to perceive a conceptual framework for ongoing processes of LDC finance. Also, some practical steps can be taken now to begin facing this clear requirement for continued world growth.

A portion of the developing world has reached a semi-industrialized state. Substantial basic infrastructure now is in place. Populations have acquired enough modern skills and management capacity to develop human and material resources rapidly. However, the further the semi-developed "middle income" countries go in that process the more capital-intensive their economies become. The need for additional funds from abroad grows even with the best of policies and with vigorous trade. Most of such LDC borrowers will have to improve their incentives for internal savings and foreign equity investment to enhance these sources of funds. Industrialized countries will have to allow imports from LDCs on workable terms to enable them to earn more foreign exchange. A number of LDC's, over time, need to reduce their total debt in relation to domestic output and exports. However, the middle-income countries with the best possibilities for development will still need large amounts of credit for their expanding production. The more successfully they grow, the more they will be able to use credit soundly -- until they are themselves capital exporters.

Most of the middle-income developing nations have huge resources of land, minerals or labor which they can turn into goods to sell on world markets. To do that they need equipment for transport, factories for processing, harbors for shipping and energy to move it all. Many of these development tools must be imported by using savings from abroad. The issue with such countries, as with large expanding domestic firms, is not whether they ever repay all loans but whether they continue to service their debt and have access to capital markets to provide renewed flows and economic growth. Analysis of their future success in such servicing should focus primarily on their resources and on what they do with their money - both the transfers of savings from abroad and their own (much larger) capital formation from domestic savings.

Professor Albert Fishlow at U.C. Berkeley, has summed it up in one sentence, "In the final analysis, the debt problem is a development problem." It is not an event; it is a continuum - an ongoing, built-in requirement for today's vastly more interdependent world economy. Movement of savings from surplus to deficit areas is just as important for growth in the global economy as it is for expanding sectors within national boundaries. This has been made more clear each year of the twentieth century, as world production has been internationalized. World trade and investment have grown faster than most individual nations. Trade of LDC's has grown fastest of all.

In the early post-war years the requirement for LDC finance was met to a large degree by loans from governments and government-owned multilateral institutions and by equity investment of private multi-national firms. However, beginning about 1970 the flow of official funds began to fall behind the steadily-growing need. Some of this demand by LDCs, to be sure, was artificial. Global inflation was growing and money was abnormally cheap. Policies sometimes discouraged savings and investment. Fiscal deficits resulted in distortions of interest and exchange rates. Money was sometimes wasted or stolen or badly distributed since some countries are also under-developed politically and administratively. However, the sound legitimate requirements to create infrastructure and convert resources to income have been huge and accelerating.

How will future funds become available? Along with responsible U.S. fiscal policy and the maintenance of reasonably free world trade, this is one of the most crucial international economic policy questions for the future prosperity of the American people. Yet, no major U.S. or other government entity and no major multilateral government institution appears to be planning practical programs of the scale and of the type necessary to provide an adequate answer.

Governments of the developed world for years have been falling behind the growth of sound LDC need for capital. Net grants and loans by official entities of the industrialized countries and the multilateral agencies to the largest borrowers grew hardly at all in real terms, from 1977 through 1983. In 1983, for the 36 largest borrowers from credit markets, such flows totaled 17.7 billion. The IMF estimates that when hard data are in hand for 1984-86, they will probably show actual decline of the net new official lending, down to 14.1 billion annually.

The former role of governments as providers of development finance in the 1970's was assumed to a major degree by commercial banks and firms. However, the LDC payment crises in the 1981-84 recession brought new voluntary private bank lending to a standstill for many developing countries. Even more rapidly, there was an evaporation of the company-to-company trade credit on which many LDC private companies had depended heavily.

The main injections of new, fresh funds into the system have been the additional advances by commercial banks under rescheduling agreements, usually accompanied by smaller amounts loaned by the IMF and governments of the OECD (Western Europe plus Canada, Japan and the U.S.).

Apart from the IMF's temporary help and some very short-term bridge loans from time to time by the Bank for International Settlements and the Federal Reserve Bank of New York, the proportion of total official long and short-term credit facilities for LDC's has not grown significantly in response to the crises of recent years. Meanwhile, due to the shrinkage of their economies debt in relation to G.N.P. has actually risen in some LDC's. In general, loans did not go up. Production went down.

Various international economists in both the public and private sectors as well as the IMF staff have estimated the ongoing total external financing needs of LDC's. These estimates take a range of assumptions concerning such things as LDC growth and domestic savings, the current adjustment programs, dollar interest and exchange rates, OECD growth rates and oil prices. The IMF staff in 1984 was projecting needs rising from 31 billion dollars in 1984 to 46 billion of net new credit a year by 1990 for the 25 most important LDC borrowers. For all "middle income" LDC's the World Bank estimated in April 1985 that total current account financing requirements from all sources will be $68.7 billion by 1990.

All of these estimates assume gradual control of the huge U.S. fiscal imbalance, with low U.S. inflation and with a trend back to historic real U.S. interest rates. They also assume strong efforts by the middle income developing countries themselves to maintain sound fiscal policies, realistic exchange rates and monetary actions which will not foster major distortions in their economies. Finally they assume that the borrowing and lending countries will be undertaking and maintaining policies which will encourage local savings and foreign equity investment. Many LDC's will have to place greater emphasis in the future on internal savings and capital formation in order to maintain foreign debt service within manageable limits. The IMF and World Bank, therefore, must continue to press for realistic exchange and interest rates and for fiscal policies which will encourage more local investment. New growth in most cases, however, will only come with renewed credit for imports from the industrialized countries. The periods of time necessary for adjustment of existing policies by individual countries are some of the most important variables in the many estimates of credit needs. While the exact numbers vary, most of the available projections show that sound LDC loan demand to create the economic growth needed by the world economy will exceed sound supply if all parties stay on the same course.

Some bankers and economists have argued that better LDC policies, satisfactory OECD growth and return to historical real interest rate levels will cause the flow of credit from commercial banks again to fill the financial gap (which is assumed to have been reduced by better LDC policies). It is believed that when the results of the recent recession are tallied in terms of final loan losses, future lending to many middle income governments will not emerge as particularly risky in relation to many types of domestic corporate credits, or in comparison with many agricultural and real estate loans in mature markets. Since interest spreads on the latter have been eroded steadily by competing sources of finance, it is believed that the risk/return mix for loans of various LDC governments again will be seen as attractive in relation to other wholesale lending.

That could be the case. However, country risk perceptions of bankers are not the only variables at work. Concentration of risk already was becoming a problem regarding the largest borrowers even before the recession. Also, a great many small banks have entered the international area since 1970. Many, by 1980, already were questioning whether they could achieve the economies of scale needed for profitable international operations. Non-U.S. banks by 1980 were getting increasingly uneasy about the liquidity considerations involved in long-term commitments in U.S. dollars, since they cannot fall back on domestic markets as easily as dollar-based institutions if Euro-dollar deposit markets become unstable. (Lending in non-dollar currencies is a possible solution in some markets but so far not much has actually materialized.)

The interbank deposit market has changed considerably in recent years. The large banks which are the major placers of funds in that market now are more conscious of the return on their assets and hence no longer are using such huge amounts of interbank deposits in their foreign exchange trading and arbitrage. At the same time, the market is being fed to a lesser degree by petrodollars or inflation. As a further blow, particularly to the newer international participants, the market now perceives differences in deposit risk between stronger and weaker banks to a much larger degree than in the 70's and this can result in more costly deposits for many institutions. Finally, domestic portfolio weaknesses of large and small banks in the wake of the long recession may inhibit bank risk-taking in general, due to considerations of depositor confidence.

Estimating the potential government sources of funds to meet future LDC needs, there is a fairly wide consensus about the amounts of grants and credit available from the national aid agencies and the multilateral development lending institutions, under their current policies and funding possibilities. The range between pessimistic and optimistic projections for LDC borrowing from all government owned entities (other than the IMF) is from $15 to $20 billion annually for the 25 most important LDC borrowers. The World Bank hopefully projects that 16.6 billion of the 68.9 billion dollars of net increased funds flowing to all middle income countries to balance their current accounts in 1990 will be covered by grants from the industrialized countries, and 19.6 billion by official loans, including the IMF. In other words, it is hoped that governments will be doing about half of the job, at best. When the IMF is excluded from the figures, the projected government portion of increased finance for development shrinks further.

The IMF, as presently structured and oriented, should not really be considered as a permanent source of development credit. Its powder must be kept dry for the unexpected and reasonably transitory situations. IMF facilities should be viewed as additional reserves which can serve as bridges to policy adjustments or to longer term credit arrangements when imbalances appear, as they must from time to time.

In the end there is little real distinction between financing development and the financing of balance of payments or trade. All represent transfers of savings, all improve foreign exchange availability for the borrowers. All allow more purchases of needed foreign goods for development.

They are all fungible, and in all three kinds of credit what matters most is how the borrower uses the funds. However, each kind of finance does require its own expertise, funding connections and organization for the task. In its present form it would be very difficult for the IMF to reach much beyond its present "Extended Fund Facility". Hence we should not plan on the IMF for long-term development capital flow. We must, however, be able to count on it to meet the unpredictable shortfalls in the system - promptly and massively. These may as easily arise from policy errors of the industrial countries as from any shortcomings of LDCs.

Foreign equity investment in LDC's holds significant promise for the longer term since it brings with it technology and management skills as well as money. However, its expansion in several countries depends upon the rationalization of domestic agricultural and manufacturing sectors and upon major investment policy changes. In any event LDC's will face strong competition for funds, globally. All of these elements make it doubtful that equity capital flows, (which reached a peak of 8.8 billion dollars for the major borrowers in 1981 and declined sharply to 4.1 billion in 1984), will rise much above recent levels for the rest of this decade. That would indicate net new funds of about $5 to $10 billion per year, if policies of the LDC's are reasonable. The World Bank estimates that 16.7 billion dollars in direct investment flowed into all LDC's in all of 1980 and 1981. Direct net foreign investment in the 35 largest borrowers might conceivably reach 10 to 12 billion dollars per year by the end of the decade if LDC policies were very receptive and if they met with prompt investor response in competition with other opportunities - neither of which is certain. In any event it should not be forgotten that equity capital is not free. Over time, international equity capital returns normally have to be higher than interest rates.

The return of the local private capital which has flown out of troubled situations could be very significant in particular countries, such as Mexico, Argentina, Venezuela and the Philippines. However, the most that can be expected securely in the next few years in that category is that there would be no additional net capital flight overall. The same measures that will attract increased foreign investment will be needed to lure back locally owned private capital from abroad. This will probably be done successfully in several countries - but even when such measures are taken aggressively, experience shows that net increased flows come slowly.

Against the background of restricted availability of their own loans, rich countries' governments appear to expect that new additional LDC credit in the future will be provided to a large degree by the commercial banks of the world. The World Bank projects that the net annual addition by private lenders to the stock of medium and long term loans of middle income countries should rise by 5.6 billion dollars each year from 1983 to 1990, while it projects an increase of only 4.8 billion dollars for loans from official lenders.

Will private bank financing be available and if so will it do the job? The short answer is that bank credit will be available, but probably will not be adequate for LDC growth at levels sufficient for enduring prosperity in the industrialized world.

The managements of most private institutions with long experience in LDC lending believe that loans to governments of many middle income countries will represent sound profitable future business. However, the amounts of encouragment or intimidation that bankers receive or perceive from legislators, regulators, investors and depositors are difficult to predict with accuracy. It seems probable that regulations as well as equity and deposit markets will restrain bank lending to LDCs more than was the case in the 1970's.

Since banks are unlikely to fill the need as before, the world will be left with a gap between sound requirements and sound funding which will be unfilled - if we rely only on existing mechanisms.

The practical effect of that gap will be lower per capita LDC growth than is necessary for tolerable unemployment in both the industrialized and the under-developed worlds. That should be as unacceptable politically in the rich countries as it is in the poor ones.

II. LONG TERM SOLUTIONS

New systems of finance are needed urgently. Dozens of theoretical approaches already have been imagined. Leaders in the private and public sectors now must get on with the selection of the few which have the greatest promise, give those schemes high priority--and proceed to mobilize political support.

In the current real political world, populations--and hence governments--of the industrialized countries do not now identify their self-interest with LDC development. Therefore, there is little support for large increases in public funds for LDC finance -- particularly in the United States. Government funds have been limited for the past decade in relation to LDC growth, in relation to world trade, or compared with world GNP. Private short- and medium-term funds mobilized by (or through) international banks remain the only quickly expandable source of new funds of important magnitude in relation to the need.

The essence of solutions to the problem of continuing LDC finance, therefore, must be to use limited amounts of public funds to mobilize much larger amounts of private monies by encouraging the latter. This means bringing private credit and liquidity risks on new lending to acceptable levels in relation to return. Within this conceptual framework, governments of the industrialized countries, for their own good, should be taking urgent creative steps to stimulate and mobilize future finance of development through private markets and institutions.

Theoretically, governments might do that by partial guarantees, by participation in the longer maturities of private loans, by helping banks diversify their risk, by funding banks in a more reliable way, and by country risk reinsurance facilities. Ideal solutions would better assure that bank financing supports sound development programs and good monetary management. The priority targets of credit flows should be those countries and sectors which can most effectively use credit soundly to create new production - especially for export. Solutions should also burden the process with as little additional bureaucracy and administrative costs as possible. In any event, public and private lenders should have better access to current information and share perceptions about borrowers and about the external factors affecting LDC debt servicing capacity.

No grand plan will suffice. There are at least two profound practical flaws in most of the sweeping global "solutions" to the debt question. The first is that LDC's are not all alike. They are not all in equally difficult problems. They are not all in their present situations for identical reasons and they do not all have the same route forward. The second flaw in many solutions is that, in effect, they view LDC debt as a one-time problem and hence look backward at "solving debt" rather than forward to the permanent question of ongoing development finance. Many such schemes for handling past finance would discourage future lenders and hence would be self-defeating. The practical need is a series of helpful techniques marrying public and private risk taking, tailored to the specific unique requirements of each borrower.

The new processes which will have the greatest prospect for political support in the industrialized countries will be those in which the beneficial effect for them (through increased exports or needed imports) is most evident. The solutions most acceptable in LDCs will be those which are more likely to be predictable in terms of interest cost and availability and those in which geopolitical pressures of industrialized governments are less prominent.

The proposals which merit the most immediate and obvious attention are those that seek simply to expand the capacity of existing institutions, both public and private. These include ways to expedite or amplify the use of private bank lending by improving information, by new instruments and by financing techniques to reduce liquidity exposure. Such approaches have the advantage of timely implementation. However, schemes put forward so far do not improve materially the average debt service profiles for LDCs, nor do they reduce the credit and funding risks on new bank credit enough to attract significant increases in funds.

Another obvious course is to increase the capital of existing official institutions, such as the World Bank and regional development banks, to raise their levels of direct lending - with or without private bank cofinancing. These institutions can provide the longest term, lowest cost finance. They can link their loans more directly to development programs and good fiscal management. They have built up impressive expertise which should be leveraged with more funds. However, the 1983 controversy over the IMF quotas illustrated the reluctance of the U.S. Congress to fund multilateral agencies. Increased World Bank capital without U.S. participation would raise issues about voting control which would be difficult to resolve quickly. The World Bank recently has begun to demonstrate the capacity to respond more quickly and flexibly to changing LDC situations - often having been previously inhibited by its largest shareholders. It has accelerated disbursement of various project loans and created several new financing formulas. It is now receiving some encouragement from its principal owners.

The United States will have an important opportunity at the next annual meeting of the World Bank and IMF this month to clarify what role it considers each of these institutions should play and the degree to which they can count on U.S. cooperation. Congress also now needs to take a longer and broader view of LDC finance.

As one flexible alternative, the World Bank has been experimenting with partial guarantees on loans of private banks. This should be fully and aggressively tried in various ways and various places. We need to remember, however, that the World Bank's capacity to guarantee is not basically greater than its capacity to lend and that it cannot leverage its own capital much in private markets under its present rules. It's system of "callable" capital offers some scope for taking credit risks without cash in hand.

Last among theoretical solutions using only existing institutions, of course, is the one of simply increasing direct lending by governments. For LDCs, the advantage of this source lies in its more liberal terms. The disadvantage from their viewpoint lies in the greater scope for political pressure.

In any event, this route presently has the minimum potential for generating public support in developed countries. The U.S. has been reducing its own programs in relation to its GNP steadily under various administrations. Direct U.S. Government LDC economic assistance consistently has been lower than other industrialized countries in relation to its GNP for some years. Current U.S. budget problems do not enhance the prospects, but very recent U.S. attitudes have been more flexible.

One important threat to debt servicing which lies beyond LDC control is the possibility of soaring general interest rate levels in the lending countries. More than 80% of the interest cost for LDC borrowers consists of the cost of deposits paid by lending banks. There have been imaginative staff proposals in the IMF for a new "compensatory financing" fund to stretch out the impact of excessive surges in the domestic deposit rates of lending countries. This would be similar to the existing facilities which provide some easing of the impact of a sudden drop of income due to reduced world commodity demand or crop failures. For reasons that are not clear, the U.S. appears to encourage such an approach less than various other industrialized countries (which seem willing to share part of the potential impact of high U.S. rates).

Other schemes to level out the impact of unpredictable movements in the funding cost of banks (and hence of borrowers) on sovereign risk credits should be pursued. One of the more workable models to achieve this without IMF involvement consists in adding additional principal payments to the end of a loan in order to refinance part of the interest cost, when deposit rates rise above a previously agreed "ceiling." When deposit rates drop below an agreed "floor" there would be repayment of the last maturities. In effect this largely represents insurance against U.S. fiscal irresponsibility, with the premiums paid by banks in the form of additional total risk and by borrowers in the form of more total debt. Various borrowers and lenders appear to believe that such insurance is needed. However, current accounting regulations and regulatory attitudes discourage the acceptance of such stretch-out arrangements, by which private banks would refinance the cost of U.S. domestic monetary policies outside their control.

While several of these approaches for expanding LDC finance have merit, recent experience does not inspire confidence that any of them will produce increased flows of the magnitude needed over the long term. This has led to various proposals for new institutions.

There have been suggestions that the World Bank create a new subsidiary to amplify the volume of LDC finance by leveraging the subsidiary's capital via the bond markets. Such an entity might also invite cofinancing with private lenders or guarantee private loans. This idea merits urgent and serious new attention. The staff work is well advanced and the approach still relies mainly on established bureaucracies instead of creating new ones. The subsidiary could link financing with the World Bank's judgments about the borrowers' overall development programs. This proposal, however, does require some public funds, and under certain circumstances might adversely affect the terms of the World Bank's own bonds. Lastly, it employs the World Bank's limited lending capacity for purposes which do not very directly expedite more private bank lending, unless co-financing is improved and used a great deal more, than in the past.

Alternatively (or in addition), a fund could be created which, although affiliated with the World Bank, would be owned directly by governments of developed countries. It might raise funds from private capital markets and participate in both private bank lending and World Bank credits. Such a fund might have the potential to broaden the ultimate sources of credit beyond bank deposits and could strengthen the link between private financing and World Bank judgments on development policies. Additionally, it should not affect the bond terms of the World Bank itself, since the latter's capital would not be at risk. However, such schemes do rely on some minimum government funding or guarantees (at least initially) and also would need industrialized countries' governments to come to a consensus on policies. A further unknown is the extent to which financial markets would accept the new obligations, even if partially guaranteed by major countries. Fully guaranteed obligations of course represent no problem of market acceptance.

Such a fund alternatively might be created and operated directly by government export credit agencies, raising most of its money in private credit markets. It could participate in private credits or provide guarantees on private lending. This approach would have the political appeal of linking an industrialized country's credit more directly to its exports. However, it would also increase the potential for governments of the major countries to inject geopolitical considerations into the lending. It could result in some wasteful lending if not coordinated well with overall development programs monitored by the World Bank and IMF.

There have been proposals calling for creation of some kind of organization, owned by governments, which would purchase the existing LDC debt portfolios of commercial banks at a discount. The entity would pay for such purchases with its own long-term bonds, or with certificates representing future exports or stockpiled commodities, or with local currency, or with equity in LDC government enterprises or with some type of obligation related to the payment capacity of LDC's. In one manner or another existing bank portfolios would be replaced by new instruments of lower value. While these proposals would relieve the present debt load they would not provide for any future financing and in fact would discourage new lending to LDC's by banks and others if they resulted in substantial write-offs. As in the case of several other approaches, instruments issued by such an entity would face unknown market acceptance.

Relating debt service directly to some formula for payment capacity has the potential disadvantage of removing incentives for sound policies or disciplines in the LDC's. For instance, excessive export taxes to cover sloppy budget management could discourage exports and the LDC concerned would then wind up being rewarded for its mis-management by automatic stretch-out of its debt.

Private banks themselves (or other private institutional investors) theoretically could create, jointly, a new fund which could stand alone or be related to one of the multilateral institutions. An entity of this type would supplement or facilitate private syndicated lending either by guarantees or by taking direct loan participations, raising its funds from private markets or governments.

It might simply arrange placement of guaranteed LDC medium term obligations in private capital markets. This approach needs less government consensus to implement. It might succeed in reducing liquidity considerations in private lending, but taken alone it does not reduce the credit risks of future lending other than, possibly, to correct some over-concentration of risk. The acceptance by markets for obligations of such an entity is even more uncertain than for obligations of a new official organization. Funding could therefore be more expensive and less available .

Some of the disadvantages of the last type of approach might be mitigated if it operated with partial guarantees from governments, multilateral agencies, export credit organizations or under a multinational "reinsurance" scheme for country risk. These features would subject it to many of the problems associated with mobilizing government participation, but are well worth exploring.

There have been various proposals over the years for creation of a private, public, or mixed corporation which would write country risk insurance. Such an entity would reinsure widely, in the private sector. It might also operate with partial "last resort" reinsurance by governments, by export credit entities, or by a multilateral institution. One advantage of this course of action is the existence of a considerable body of previous study. Furthermore, some insurance of this type already exists. Such a vehicle potentially could be quite flexible. This idea obviously poses all the problems associated with gearing up any new institution. However, it merits extremely active attention.

In short, there is a wide spectrum of possibilities for future government action to induce resumption of private lending by assuming some of the risk, in order to bring risk and return into reasonable balance for private bank depositors and shareholders, as well as other investors. Unless risk and return are indeed reasonably balanced, voluntary flows of funds cannot occur.

While such techniques are evolving, governments of the lending countries, for their own benefit, should refrain from steps that reduce return or increase the risk for the present lenders. Governments can't afford to drive out the existing credit sources unless they have something to assume the task.

III. THE ROLE OF TRADE FINANCE IN DEVELOPMENT

In the search for ways to amplify credit to LDC's high priority in the near term should be given to short-term trade finance by private companies. Most studies of development finance - past and future - dwell very little on short-term credit in its various forms. The evaporation of short-term trade credit formerly extended by manufacturers and traders directly to importers and exporters of developing countries in particular is a subject that has received remarkably little attention in the discussion of LDC debt. This may be because the full role of short-term international credit in development has not been widely understood outside the business communities involved, and because it is not well tabulated in the statistics of most countries.

In "normal times," much of this credit takes the form of deferred payment by LDC importers on shipments such as industrial raw materials, fuel, fertilizers, insecticides, manufacturing components, vehicles spare parts, etc. Such credit is granted either by the suppliers themselves or by their bankers. Alternatively, it may be provided by letter of credit facilities arranged by the LDC importer's local bank with its overseas correspondent. Some trade credit consists simply of inter-company accounts between foreign parents or partners and an LDC affiliate. The latter "open account" facilities historically have been huge in some countries like Brazil and Mexico, with their many multinational manufacturing firms.

On the other hand, exports of basic commodities from many smaller countries commonly are financed to a significant degree by advances on purchase contracts made by overseas commodity firms with local processors of products such as coffee, cotton and sugar. These processors, in turn, advance to farmers a large part of the cash necessary to harvest the crops. Such advances often are refinanced by the overseas buyers with their own domestic bankers in world money centers.

"Normally", therefore, there is a continuous "float" of short-term foreign currency credit for exports or imports outstanding to a developing country which, in effect, represents a low-cost non-amortizing balance of payments loan.

Even when the various kinds of individual advances are registered and recorded in statistics, it is extremely difficult in the official totals to distinguish between foreign bank-supplied and foreign company-supplied credit or between both types of borrowing and short term capital movements. The mix of bank-supplied or company-supplied trade credit is different in each LDC and tends to shift over time in a given country, in accordance with business conditions.

Whatever the source or precise magnitude, the effect on the balance of payments of an LDC is to accelerate receipt of export income and to defer foreign exchange payment for imports. Thousands of overlapping 30, 90, 180-day or one year credit transactions constitute an "advance account" balance of transferred resources in use in the LDC. This financing expands readily when business is good and perceived to be secure. It contracts just as readily when business is bad or seems to be more risky. The "float" of such trade finance not only represents a loan in foreign currency for the LDC as a whole. It is also an important source of working capital for thousands of private entities.

This "float" is seldom recorded or noticed in macro-economic analysis when it is functioning smoothly. In countries where conditions are quite stable and predictable and where both exporters and importers are long established, most credit of this nature is granted by suppliers or buyers directly to their counterpart traders. There is no bank in between the traders. For instance there are very few letters of credit in trade between the United States and Germany and there have not been many since Germany fully recovered from World War II a quarter of a century ago.

When either a country's condition or the situation of one of the private trading partners is perceived to be less secure - but still considered to be capable of evaluation - banks tend to appear in the picture, as openers or confirmers of letters of credit, as discounters of bills of exchange or as lenders against portfolios of export "accounts receivable".

When a country has been in serious problems for a number of years, such as the European and Asian countries were during World War II, the beginning of recovery of trade credit often can only take place under the guarantee of exporters' governments. In the case of the Marshall Plan, for instance, the first letters of credit confirmed by U.S. private banks covering exports from the United States to post-war Europe were covered by United States government guarantees of reimbursement, with the U.S. in turn guaranteed by the European country's government.

As bankers became experienced in these letters of credit and were able to evaluate the credit and country risks more clearly, they began to confirm German, French, Italian and Japanese letters of credit on their own.

As U.S. exporters had satisfactory experience in shipments under such letters of credit they began to waive the requirement for the U.S. bank "confirmation", accepting only the obligation of the foreign bank. The next step was to do away with letters of credit and ship the goods on open account credit to the buyers, without any bank intervention at all. This pattern continues today for most of Western Europe and Japan.

When conditions deteriorate in a country, the first tendency towards contraction of credit usually takes the form of suspension of risk-taking by exporting companies with regard to new direct credit transactions. In practice they usually ask their trading partners to go to their banks to open letters of credit. This usually keeps the exports moving until existing committed lines of credit of the LDC banks from their overseas correspondents are filled - or expire.

Any export guarantees or insurance will be used as long as available. At that point, to the extent that the importer has cash, the importer purchases hard currency drafts from its central bank and sends them to its supplier.

If the country in question has a great many importers which have been using such short term credit for a long period of time, then the normal "permanent non-amortizing loan" which the country has had outstanding for years all of a sudden is amortized. No new credit goes into the pipeline and each 30, 90, 180 and 360 day maturity has to be met.

The mechanism by which maturities are met is the draw-down of central bank reserves by the local firms' purchases of dollars. Those purchases are completely indistinguishable from "capital flight". Usually, no one can identify or quantify from written data whether dollars have been bought by an importer to liquidate long-standing merchandise trade credit or have been purchased with the proceeds of a local savings account by some other resident of the LDC, who just wants his money out of the country.

The main lesson in this cycle of trade finance is that, to the degree that short term trade finance does not exist, the country has to raise larger amounts from other sources. These may be national savings, foreign equity investment, long term official loans or private bank credit. Another lesson is that the apparent "capital flight" from any given LDC entering into trouble often contains substantial transfers which are, in fact, repayment of non-recorded debt for previous imports. (Likewise an expansion of company-to-company credit can appear to be a re-flow of private investment). A final lesson is that local private companies often are benefited more directly by the float of trade finance than by many other types of savings transfers from abroad. They get not only foreign exchange, but also more working capital.

Clearly the "float" of short-term trade credit is an important element in savings transfer from capital exporting countries to LDC's and more attention should be given to the subject, while other more elaborate mechanisms for long-term investment are studied and tried.

IV. PRACTICAL STEPS NOW

National export credit guarantee organizations (such as EximBank and FCIA, Britain's ECGD the French COFACE, etc.), should be expected to provide fairly quick increased company-to-company credit for LDC trade. These organizations have passed through a period of freeze on new trade guarantees for countries entering re-scheduling, but their attitudes now seem to be changing. They can and should do much more inspite of the fact that some have had their finances strained by the recent recession. Production in various LDC's is picking up and import needs are rising. Such government export credit organizations increased their credit to LDC's at approximately the same pace as private commercial banks in the seventies and stopped their activities at least as abruptly when clouds gathered. Some have rescheduled LDC debt owed to them, but most have not provided much new money and most of them have been more reluctant then private banks to enter into multi-year rescheduling, until very recently.

The World Bank estimated in April 1985 that net disbursements of such government loans and guarantees for exports to developing countries contracted from 13.31 billion dollars in 1981 to 7.60 billion dollars in 1983. Such credit dropped from 12% to 8% of the total receipts by developing countries from all sources.

Virtually all such entities in the various industrialized countries are either government-owned or government-sponsored and encouraged, with operating policies largely set by governments through boards of directors or management. Private bankers and exporters observed that during the crisis years of 1981 and 1982, the practical availability of new guarantees from these organizations for exports to "problem" developing countries contracted steadily. An informal survey in early 1984 by leading bankers in eight industrialized countries, based on conversations with exporters, bank lending officers and the guarantee agencies themselves, showed that government-sponsored export credit guarantee organizations in general were still in practice avoiding new transactions for most rescheduled LDC's. In a number of cases, the avoidance of new government export credit guarantees was announced. Sometimes it took the form of sharply poorer terms which were in practice unworkable. Often, it was simply a slowdown of approvals or informal indications that it would be useless to apply. Meanwhile many old transactions matured and were paid. Since the rate of new transactions fell behind the maturities of their own previous short term and long term loans, the total commitments of the various government export credit organizations dropped, for the borrowers with the biggest problems.

For Argentina, Brazil and Mexico they apparently fell by over $4 billion from 1980-1984. This was inspite of very large specific new facilities for Mexico and Brazil to accompany new money from commercial banks and the IMF.

Availability of government guaranteed short-term trade credits particularly for troubled countries declined precisely when and where it was needed most. According to a recent IMF study official short term trade credit and guarantee commitments for Argentina dropped from about $700 million in 1980 to $300 million in 1982. For Brazil they dropped from roughly $900 million to $500 million and for Mexico they went from around $1,100 million to $600 million, in the same two year period.

In the worst of the crisis, when governments were wisely advising private lenders not to panic, the government export credit guarantee organizations apparently cut their short term exposure in half for those three most critical countries.

This retreat not only affected the ability of exporters to continue granting guaranteed company-to-company credit. It also contributed to the shrinkage of short-term bank credit lines since some bank credit previously was based on government guarantees. Finally a great many exporters who had extended overseas credit at their own risk in the past took their cue from the actions of the government guaranty organizations and attempted to reduce their exposure. For many LDC's, the cut-off of company-to-company credit preceded the reduction in commercial bank credit. Indeed, in some countries, the rapid reduction of supplier credit contributed to a quick upsurge of short-term bank borrowings at the beginning of the crisis. This happened when committed but unused credit lines of LDC banks with their U.S., European and Japanese correspondents suddenly filled up due to a new requirement of suppliers that orders be accompanied by letters of credit.

According to an IMF report in August 1985, there are hopeful signs that the negative effects of the 1981-1982 export guarantee policies now have been more fully recognized by the agencies of several countries. The World Bank and IMF staffs themselves have been promoting more attention to the subject - most recently at the IMF "Interim Committee" meetings in April 1985. It appears that from 1982 to 1983 total official export guarantees to all LDC's - to both the thriving ones and the troubled ones - actually rose slightly (7%). Meanwhile risks for governments have been reduced significantly by commercial bank rescheduling and by additional private and IMF lending based on LDC adjustment programs.

With return to economic growth in a number of major LDC's and with excess productive capacity being used up in several countries, import requirements of the semi-developed countries again are rising. There is a need both for dollar credit and for more working capital in local currency for private firms. Requirements for imported raw materials in many LDC's, of course, have never stopped completely and now appear to be expanding. The need for imports of capital goods such as machines and tools and spare parts, which dropped dramatically in 1981-84 soon will reappear. Infrastructure for transport and power is more fully employed, along with temporarily "excess" manufacturing and agricultural capacities.

The need to start up the normal trade financing cycle again is becoming evident in Mexico, Brazil and many other places. Logically, as in postwar Europe, trade credit can best be encouraged again by rapid expansion of government trade financing guarantees, preferably coordinated and encouraged by the IMF or the World Bank. Such multilateral involvement is needed to accelerate action, and to relieve the fear of each national agency that it will be caught off-base with increased risk all alone. Finally, cooperation is needed to advise against uneconomic supplier credit which might help some political sector in the industrialized country, but would work against sound development strategies of an LDC.

Expanded export credit guarantees represent the most logical way for industrialized countries to assist LDC's at this point. It is also the most obvious thing that industrialized countries can do to help themselves, by regenerating export-related jobs. It should be the most supportable form of economic assistance from a polical standpoint, in the developed countries, since the effect on their own employment is more immediate and obvious. Furthermore, since such guarantees usually do not require cash unless they are called, the impact on developed country budget deficits could be less than that caused by the same amount of government loans. This is true because the probability of cash being needed to reimburse payments in excess of reserves under all such export credit guarantees at once is relatively small. The budget effect will vary from country to country, depending partly on the financial situation of the agencies. In some cases trade finance guarantees could be expanded by existing institutions within existing budgets or with very limited expansion of spending authorities. In others, existing capital has been badly depleted by recent events and would need replacement.

A greater amount of total economic assistance often results from trade credit guarantees than from other types of credit. The productive private sector is assisted more directly. Also, each government guaranteed credit tends to generate additional private risk-taking. Most government programs of this type require that part of the risk be taken by private banks or exporters.

It will take years of trial and error for the necessary new mechanisms of public-private cooperation in long term LDC finance to evolve. However more rapid expansion of government export credit guarantees can and should be undertaken now. Some of these agencies have begun rising to the task recently. Most of them apparently resist being pushed, but some way should be found to move them ahead faster. Because increased export credit guarantees would directly and obviously create additional jobs in the industrialized countries, it should be possible to mobilize non-partisan political support, with strong leadership. Delay in this simple, obvious and self-serving step by the rich countries at this critical point would hold back their own long term growth needlessly.

In the long run this may or may not be the best manner of public-private cooperation in savings transfer to developing countries. The most important permanent need clearly is for medium and long term credit and equity to be serviced over the time necessary for new productivity and new exports to be created. However, in the immediate future, trade credit guarantees should be the most workable way, technically and politically. The United States, as the largest shareholder with the most to gain from LDC growth, should encourage the World Bank and the IMF to lead a coordinated, rational expansion of short term government-guaranteed trade credit now, as the first step of re-generated resource flows for world growth.

Senator **Mathias**. Let me go back to Mr. Heller to start with. On page 6 of your statement, you express some views that are extremely bad news, bad news I think for the U.S. Government which has been trying to cope with this problem, and bad news all over.

As you say, you ask the question, "Are international banks likely to increase their foreign assets faster than their domestic assets?" And the answer is no.

Then you go on to take a rather pessimistic view of the expansion of foreign lending by the private sector banks.

Do you feel very strongly that this is likely to be the trend in the immediate future?

Mr. **Heller**. Not that it is desirable, but I think that will be the trend, yes.

Senator **Mathias**. Now, I think we both agree on that. And, of course, as I gave you the actual case with which I was familiar of Bank *x* yesterday, in which they had already made substantial loans in South America and simply had closed the window down and said enough is enough.

Mr. **Heller**. Certainly. In many cases you had banks participating in short-term trade finance and now that these short-term trade loans that were rolling over every 3 to 6 months have been rescheduled into 5-, 6-, and sometimes 15-year medium- and long-term loans, the Bank will say well, we have already that much outstanding in that particular country. So new trade finance isn't discussed either because it would mean an increase in the total exposure.

Senator **Mathias**. So it is for these reasons that you say on page 7 that this signals a "permanent deemphasis of foreign lending"?

Mr. **Heller**. I think as a generalization you can say that. I think many American banks have closed offices abroad or have announced intentions to deemphasize the international sector and reorient on the domestic sector.

Senator **Mathias**. And, of course, if you are right—and I am certainly not contesting your view on this—but I just say, if you are right, that will make a great difference to Senator Baker, in the kind of thinking that he is doing, and the sort of thoughts that he is expressing on this whole subject.

Mr. **Heller**. Well, we very much welcome Secretary Baker's leadership and appreciate that the U.S. Government is taking a more active role in trying to come to grips with that problem.

Secretary Baker has a plan for the developing countries. He has a plan for the commercial banks to increase lending by $20 to $25 billion over the next 3 years or so to these countries.

He also has a plan to strengthen the World Bank and also the IMF. I think that that is very much needed and very much appropriate.

The only thing I would like to see is also some direct positive action by the Government itself. And I think the Eximbank of the United States would be the appropriate vehicle in that respect.

Senator **Mathias**. Mr. Wesson, I find it interesting that you are here with us today representing the Hoover Institution.

Mr. **Wesson**. Oh, I beg your pardon, sir, I am representing myself.

Senator **Mathias**. But I understand you are associated with the Hoover Institution, and you are speaking for yourself.

Mr. Wesson. I am speaking for myself entirely.

Senator Mathias. We will make that distinction in the record.

Mr. Wesson. It is a great institution.

Senator Mathias. It is. And I think it is interesting that it bears the name of Herbert Hoover who would have been extremely interested in this problem and who would probably have had very practical insights into what to do about it, both from his experience in dealing as a private businessman in the international world and from his later experience as the first great administrator of public projects of international activity.

So on both fronts, Hoover could have brought a great deal of experience to bear on——

Mr. Wesson. He is the man who declared the moratorium on the debts in 1930.

Senator Mathias. Yes, absolutely. Well, not knowing what President Hoover might have said on the subject, we do know what Arthur Burns has said on it. And I have quoted Arthur Burns several times during these hearings.

But he wrote an article a year or so ago in Foreign Affairs in which he referred to his long career as a banker, and said he had seen many cases as a banker dealing with private transactions where the final push from a liquidity problem to an insolvency problem was avoided by the exercise of great creativity and ingenuity.

There were all kinds of arrangements he referred to, going all the way from a temporary moratorium to stretching out the payments to lower interest rates to all of the different panoply of solutions that the private banking industry used to keep their customers alive so they could some day pay debts. He suggested that the same kind of ingenuity should be applied here

Now, in your statement you made some suggestions of this sort, that new and innovative arrangements that might not exactly fit the traditional banking practices could be applied.

Mr. Wesson. I believe it is essential. And I don't think the traditional practices can possibly solve the problem. I would like to interject that it was suggested that debt might not be excessive.

A little comparison there should be made—I allude this to Mr. Fishlow. The debts that were repudiated after the First World War called for payments equivalent to perhaps 2 percent of the GNP of France, Germany, whatever.

Currently, the debtor countries are expected to pay anywhere up to 6 or 8 percent of the GNP. In other words, differing by a factor—the repudiated debts were less of a burdensome by a factor of perhaps 30 to 1.

Senator Mathias. What about the question of capital flight? How would you figure this into your creative solution, sir?

Mr. Wesson. Well, that is a problem. Now, we were talking about sending more money down there or getting investment down there. Latin Americans are still taking the money out. And I think they know the situation better than the bankers in New York.

Senator Mathias. You think that is their practical verdict on the local outlet?

Mr. Wesson. I think they knew what they are doing.

Senator **Mathias**. Well, if you look at the major Latin Ameican debtor nations, almost everyone of them has experienced some capital flight.

We know a lot of it has ended up in Miami, at least the first stop in the United States has been Miami.

Is there anyway to quantify the amount of Brazilian and Mexican and Argentine funds that are in accounts abroad? Do we have the statistical ability to make an accurate estimate of that? Either an accurate estimate or——

Mr. **Wesson**. There is no accurate estimate. There are guesses which are largely based on discrepancies in the accounts. But the estimates, I suppose, have some relation to reality.

The interesting piece of information there is that the capital flight from Venezuela is approximately equivalent to the amount of the debt. In Mexico I think it is somewhere in the range of 40 percent, 50 percent of their debt. In Brazil, much less.

Senator **Mathias**. So we have a catch-22 here.

If those funds are to return, they are probably only going to return when the prospectus for improvement in the local economy are good enough that people have the confidence to bring them back.

But the other side of the coin is that maybe the prospects won't look better until the money gets back. So what do we do about that?

Mr. **Wesson**. Catch-22. Well, the only thing it seems to me is to try to bring about investment which would improve the economy. I mentioned the possibility of setting up some kind of fund.

Something like that has been mooted [sic] in terms of requiring banks to reinvest part of payments received. Now, I don't know how that would be reinforced. That is, unless your base that has been brought forward is a possibility which would amount to essentially the same thing.

Senator **Mathias**. Mr. Heller, do you have any views on this capital flight question?

Mr. **Heller**. Yes. The World Bank has tried very hard to put some numbers together, and in some countries there are astoundingly large percentages exceeding the total amount of bank lending that has taken place to these countries.

I don't have the data with me today, but if you are interested I would be glad to submit that for the record, later on.

Senator **Mathias**. I think that would be very interesting. If you would let us have it, we will include it in the record.

Mr. **Heller**. The numbers are very large. Clearly, it is difficulty to argue what is capital flight. What is capital flight in Latin America is prudent portfolio diversification on behalf of an investor in an industrialized country.

And if you put it in those terms, you know, what would you do if you were sitting in Argentina? Yet, for the problem at hand here, it is a serious problem.

It is very, very difficult to come to grips with it. And if you advocate further Government regulation and tighter exchange controls, all these are things that we generally dislike and that we do not want to see implemented for the further health of these economies.

So the only way to tackle this problem is to go at the root of it. What is the cause of that excessive capital flight that we are seeing?

And here I think improvement depends squarely on restoring economic conditions in these countries, giving private investors that are living in these countries confidence that they will be able to keep the fruits of their labor in these economies themselves.

Senator **MATHIAS**. Mr. Wesson.

Mr. **WESSON**. Speaking of portfolio diversification, I was told in Costa Rica once the housemaid was buying $5 a week in order to send to Panama.

Senator **MATHIAS**. Peter.

Mr. **JONES**. Senator, on Arthur Burns' article that you mentioned and this need for creativity, two or three comments.

One, Fred Bergsten, of the Institute of International Economics, has come out with an excellent new study with some two dozen proposals of various innovative techniques in combination which could be used to alleviate the problem, somewhat.

We worked on some of those with him, and endorsed most of them as useful, even necessary, approaches, including things like interest capital.

Second, on Mr. Wesson's proposals on converting debt to equity—and he said new equity—there is a very large industrial group, the Alpha Group in Monterey, that has in fact converted their debt with their foreign bankers to equity on the existing debt in very large quantity.

And Cordell Hull was telling me some weeks ago about these problems which were mentioned yesterday with U.S. energy companies in the Southwest and the fact that a number of them are close to bankruptcy. And a number of U.S. banks, however reluctantly, are converting some of their debt to equity in this country as a way of easing the situation.

There are precedents for this.

Senator **MATHIAS**. How does that work mechanically?

Mr. **JONES**. Cordell, can you elaborate on that?

Mr. **HULL**. When you and I spoke, I was referring primarily to an analogy to troubled companies in the oil and gas or oil and gas service sectors in this country.

Here, there have been instances where banks have agreed in essence to take part of their debt and do a stretch-out of repayments coupled with a lowering of interest rates. And then in some cases convert a part of the debt to equity.

Mr. **JONES**. Do they hold it and then sell it all?

Mr. **HULL**. Well, I think that it is fair to say that all these companies probably had not yet reached a turning point—because of the problems in oil and gas generally in some sectors of the country—where the bank reached that decision point as to what to do.

But obviously, if the companies become viable again, as we see a turn in the economics affecting that sector, then at some point if you keep the company alive the stock will become worth something. And I presume that they would sell at some point.

If I may, Senator, I would like to make a point on the creativity issue which has been mentioned. Here there are two fundamental aspects. One is dealing with the problem and the mechanics of the problem as they exist today. And it seems to me the conversion of debt to equity is one of those mechanics. Stretchout of debt is still another mechanic. Lowering of interest rate is another one.

But I would suggest that it would be more worthwhile in prioritizing creativity response to give the most emphasis to those things that get world economic growth growing again.

And I would like to suggest again, in case there was any misunderstanding, that if this debt is excessive today, it is only excessive in relationship to baselines of current worldwide economic activity.

If you would go back to the period when many of these loans were made—and I participated in some of them on the banking side in the 1970's—I suspect that if you looked at country economic projections at that time, country economic projections during the 1970's projected a much more substantial economic growth than is occurring in the affected countries right now.

So in the long run, what may appear excessive debt today was not necessarily excessive in relationship to the debt servicing levels that were projected then on the basis of some reasonable growth of world economic activity.

I would like to emphasize again that the fundamental problem—it comes back to many of the concerns that we have in this country with the budget deficit, strength of the dollar, the stability of foreign exchange rates, and so forth.

Senator **Mathias**. A number of proposals have been made for easing the servicing problems that the debtor nations are encountering. One example, capitalizing the interest.

But all of these proposals, whatever form they take, incorporate the fundamental problem that they create a disincentive for future bank lending.

Is that true, Dr. Heller?

Mr. **Heller**. I wouldn't say they all created a disincentive for future bank lending. For instance, I think some of these proposals to capitalize interest, they are certainly worth investigating, worth implementing. Because they reduce the sensitivity of the cash flow to short-term interest rate fluctuations. And in that sense, I think they are very much like mortgages. If you have a flexible-rate mortgage, you may have a limit to the amount of the rise in interest rates that you would have to pay in any given year, and it would be added on at the end of the loan. When interest rates fall, that would be subtracted from the total amount of the loan.

So rather than having flexible payments, you would have a flexible maturity of these loans. And I think those innovative approaches are well worth taking.

Mr. **Jones**. Senator, Paul Volcker mentioned at a meeting this summer that he had been asked to discuss with several Latin American countries the level-pay mortgage that Bob Heller is talking about. It is quite common in the banking industry in this country—you buy a house and you only have to pay so much of your salary per month because that's all you can afford. And if the interest rate goes above that, it is added on at the end.

Volcker had discussed this with some of the Latin governments 3 years ago. At that time they were not receptive. They didn't want the addon. But there is some sense now that this quite common practice in American banking in our own country might very well become more acceptable.

Senator **Mathias**. Now that is a common accepted practice. But let me ask Mr. Heller this.

Are there limitations in the commercial banking regulations that would inhibit this kind of creativity?

Mr. **Heller**. Well, right now the accounting rules are often a hindrance. If you have a loan that is not accruing right now, then you would restructure in that fashion that we are talking about. Then that would be considered as a nonperforming asset at that particular time. The slate is no longer clean, in other words. If you, on the other hand, make a new rule loan, everything is well. I think in accounting rules, those are fine distinctions, but, we could be a little more creative and not let that be a barrier to progress.

Senator **Mathias**. Now, Mr. Wesson has made some suggestions that probably would not fall within the orthodox current account rules. Would that——

Mr. **Heller**. First of all, if I understand it correctly, we would be paid in local currencies. And, second, that the local currency would be turned into equity investments.

First of all, I don't think banks are very eager to be paid in local currencies that are often depreciated at the rate of 200 and even 1,000 percent a year. The question is then, how much is your payment worth after a very, very short time period.

Second, if you index it all against price level changes, then you are coming up very much exactly the same as with U.S. dollars.

So I think to a great extent you are just talking about reinvesting in equity in these various countries. I think as a general rule banks like to stay in the banking business. We don't want to run vast industrialized enterprises in these countries. It would be a very difficult thing for us to do from San Francisco or from New York.

I think the situation is very much analogous to the American farming industry. Bank of America is now the largest landholder in the State of California. We don't want to be the largest farmer in the State of California. We would much rather have people who know how to farm run these farms. And there is absolutely no reason to expect that bankers will do a better job on that land than the people who just went broke on it.

I think the same observations pertain to these industrial enterprises that we are talking about in the developing countries. If they are not viable right now, just the fact that American brokers are suddenly the owners and involved in the management, do not guarantee the future prosperity of those institutions. On the other hand, it may be better than nothing.

Senator **Mathias**. Mr. Wesson.

Mr. **Wesson**. It would very much be better than nothing. But it would not be feasible to think in terms of taking over existing enterprises. That is not acceptable politically.

It would have to be making capital available for doing new and more productive things.

Senator **Mathias**. Peter.

Mr. **Jones**. I observed the efforts of the Chilean Government under the Christian Democrats to achieve a phased selling off of certain existing state-owned enterprises that they felt were inefficient. They did have to take a discount, but I am told in some cases they did find new people to come in and operate them.

One of the suggestions here is, as Professor Fishlow said, that the public sector is now viewed by host governments as bloated. There is too much state-owned enterprise for efficiency and growth. They have got to begin to get out of some of those state-owned enterprises anyway.

Some of those state-owned enterprises are part of the foreign debt problem. It would be helpful if you could sell off some of the equity maybe to local private enterprise in joint venture with foreign private enterprise, so that the foreigners would pay some dollars and the locals would pay some local currency. The banks would act as a intermediary and convert their debt to equity.

But the equity would not be permanently held by the banks but would then be sold into the private sector as part of the generally recognized need for privatization. It seems to me that this is an approach that with the private sector Monterey Alpha Group has been partially tested. And it worked there in the sense that foreign banks converted some debt to equity. It has worked sometimes in Chile. The Argentines are talking about selling off some of their state-owned enterprises. I think it is an area which may have some potential, especially since these State enterprises are assets which could be used to reduce the outstanding debt.

Senator **MATHIAS**. Mr. Hull, you looked a little bit nervous as this kind of solution was proposed. How would large enterprises that are engaged in international transactions feel about having to settle up on that kind of basis?

They wouldn't have the bank examiners questioning it, but they might have other limitations. Mr. Hull's response here was in answer to the Senator's question on how multinational corporations felt about converting debt to equity. This question seems to be missing.

Mr. **HULL**. Well, by and large I would suspect that the large multinational companies dealing in these countries are not in the same position. They are not in a creditor position.

And to the extent they have positions in these countries, they are probably already largely involved in an equity investment. So I don't think the issue would present itself to a nonbanking institution.

Senator **MATHIAS**. It is not the nature of the beast?

Mr. **HULL**. Just not the nature of the beast.

Mr. **JONES**. Couldn't they buy into some of these state-owned enterprises at a discounted price? I am told that a few U.S. companies did buy state-owned enterprises that were viable a decade or more ago for a decent price because they thought it was good business.

Mr. **HULL**. I would think that, provided you had a local host country environment that was conducive and that would be supportive for investment, and provided you had some mechanism in place for political risk insurance over long periods of time—and we do have some vehicles in this country for that—that such opportunities would be evaluated along with any other investment opportunity. Is it reasonable use of funds to invest in those opportunities?

And I think also that it would depend to some extent on not simply just the economics of the matter, but also what continuity of interest did the particular multinational company have in that country. And did it really want a presence in that country for some reason?

Senator MATHIAS. Dr. Heller.

Mr. HELLER. Senator, if I may add a footnote to that. There is much discussion regarding the Baker plan to provide new funds to developing countries by commercial banks.

I think one thing that would be very helpful is that if the funds that we make available to finance direct investments by large or small U.S. multinational corporations to those countries would count toward that additional money that is being talked about in the Baker plan.

So if IBM or Levi Strauss or——

Senator MATHIAS. Not only direct loans but loans through third parties?

Mr. HELLER. In association with them. If IBM wants to build a Mexican subsidiary, or Levi Strauss wants to build a plant in Brazil, then we could finance the plant. In that sense we would be financing direct investment, but by an American corporation. We would find that a lot more comfortable than making additional money available without strings attached to the government.

Senator MATHIAS. That would be an exception to your observation that there is a deemphasis on foreign lending.

Mr. HELLER. Well, you know, we would rather see it take that particular road rather than——

Senator MATHIAS. You can rely then on the credit of the domestic lender, as well as on the project that is undergoing in another country.

Mr. HELLER. We may or we may not get a guarantee by the parent in the United States. Obviously, we would prefer the parental guarantee. But even if you don't get the parental guarantee—and in many cases you do not get it—at least we would have more confidence in the viability of the project.

And, second, I think in yesterday's hearings and in today's hearings again, there was a constant emphasis on the need to have more direct investment taking place in these countries. And that is one way in which you can channel it.

Mr. FISHLOW. Senator, I think that Mr. Heller is perfectly right with regard to the preferences of the banks. The great problem is that that winds up double counting. You can't count your foreign investment in the first instance as being a net inflow of foreign exchange and then also count the banks against that total and come up with the same amount of foreign exchange requirements that you ultimately need.

I think one has to be careful to understand that one of the reasons for making the banks lend additionally in this fashion that Senator Baker has proposed is precisely because the foreign exchange is necessary.

I think we should not in fact lose sight of that consideration.

The second observation I would make is your earlier and quite correct notion that one of the reasons why creativity perhaps has not been explored as much is the fear that bank lending won't be available in the future if one goes to various schemes.

I think there the vision that one should take is really a medium-term one in which it shouldn't really be there. I think that we are being inhibited falsely by having a model that still views the likelihood of substantial commercial bank lending occurring in the decade 1990, or in the year 2000, as an important basis of financing developing countries.

I don't think it will recur. I think what we have to understand is that what happened in the 1970's was an accident. And I think what we have to see the current policy objectives as being is getting us out of the consequences of that accident by calling upon the commercial banks to put up what is necessary to ease our way out while at the same time you look at the medium-term problem in a different fashion.

Senator **Mathias**. One final question that occurs to me as to the role of banks in the whole picture. We have talked about capital flight. Is there any way in which the banks can be induced, perhaps against their own interests, to reduce the net outflow from developing countries?

Mr. **Heller**. Well, Mr. Chairman, that is individual decisionmaking. And as long as you have got some countries in the world where you do have very strong secrecy laws—and we all know the countries involved—it is impossible to monitor that in any effective way, shape or form.

Senator **Mathias**. I raise this subject with some trepidation, particularly in light of the laundry cases that have been publicized in recent months. If banks are not even going to be able to enforce the laundering regulations, it is unlikely that they could move in this area.

But I just wanted to raise it to see what your thoughts were.

Mr. **Heller**. Yes, I don't think there is much of the capital flight taking place that somebody walks in and says, here, I want to open an account at your San Francisco main office. Most of that takes place offhsore, and therefore it is very difficult to monitor.

The very purpose of it is tax evasion in these other countries. So——

Senator **Mathias**. They go to a London banker?

Mr. **Heller**. Well, I don't want to point to any one specific country.

Senator **Mathias**. No, I will ask you. They go to some banker, some offshore banker, some banking center?

Mr. **Heller**. That is right. And there are countries with very strict secrecy laws as far as banking is concerned. If you walk into banks in some foreign countries, they won't even ask you for your name. They won't ask to see your passport. All they want to do is agree on a code number.

If you tell them it is 4711, that is the only identification that bank will have in regard to the transaction that you engage in.

Senator **Mathias**. So that what you are telling us is that there really is no practical control from that point of view?

Mr. **Heller**. There is no practical control. And I think for the U.S. regulatory authorities to attempt that kind of control, you know, would just be totally ineffective.

Senator **Mathias**. Would you say it was as quixotic as the International Corrupt Practices Act?

Mr. **Heller**. It is in the same league.

Senator **Mathias**. You don't have to answer that.

Yes, Peter.

Mr. **Jones**. I would like very much to ask Bob Heller for a comment on the following.

It has been stated by Rimmer De Vries in writing of Morgan Guaranty that in the last 3 years the banks have substantially improved their positions. They have taken out $30–40 billion in interest payments from the developing countries.

They have increased their capital. And they had an opportunity during these 3 years to build up their lost-loan reserve against these potential bad debts. And Rimmer told you, Senator, and me and others in Argentina last November that for the smaller countries the loss-loan reserves in a number of the banks are now in place so as to substantially reduce the risks that they had been running in case some of these countries defaulted.

One view is that the last 3 years have been the 3 years of the banks, by the banks, and for the banks, to strengthen their own position relative to what they were 3 years ago. So that today, if there was some slowdown in payments or some default, as long as it wasn't across the board and total, American banks are in fact in much better positions vis-a-vis these debtor nations than they were 3 years ago.

They have had an opportunity to strengthen their position. And they have done it in many cases. Therefore Baker comes along now and says for your own further protection, and for U.S. national interest, put up another $20 billion over 3 years which is a 2½-percent increase a year in your current position—not all that much. It seems to me that that is not an unreasonable thing to ask the banks to do in their own interest.

Is there any major flaw in that analysis, Bob? Have the banks in fact not only had an opportunity to improve their positions vis-a-vis these loans, but have done so?

Mr. **Heller**. All the American banks have greatly increased their capital. As I said earlier, they have roughly doubled the amount of capital over the last 3 to 3½ years.

So there is increased strength in the American banking system. But it is not only the capital positions that count. I think it is also current earnings that count. And here you see very large differences among various American banking institutions.

Some institutions who happen to be in the right areas of business are doing very well indeed these days. And some institutions like our own bank, we are heavily engaged in American agriculture, for instance. We are the largest private agricultural lender in the country. That, added to our difficulties abroad, produced a loss of $338 million last quarter alone.

Therefore, the ability of the bank to engage in concessionary interest rates or making other loans available that will then be criticized by the regulators as soon as they are being made, that ability is clearly limited.

I think that quandry really has to be explored. Do the regulators turn around after we have made additional loans and then say, well, now your exposure in country A or B has gone up and now you have to either write off these loans which you just made at our urging, or you have to increase your reserves against these loans. That is the quandry that you are really in.

You know, it is sort of like you are out on the street and the policeman says, well, lead the way to the hospital, do it as fast as you possibly can, we have go to get there. But don't do anything wrong on the way while you are doing it, I will be watching what you are doing.

It is difficult. It is a difficult process. And you get very, very conflicting signals from the regulatory authorities.

Senator MATHIAS. Ever thus.

Mr. HELLER. Right.

Senator MATHIAS. Well, I am very grateful to all members of this panel for your observations and useful additions to these hearings, and I thank you very much for being here.

We have one more panel in these hearings. Mr. Burke Knapp will talk on "Credit Flows and Guarantees of the Multilateral Lending Agencies."

Mr. Knapp, it is a pleasure to have you with us.

STATEMENT OF J. BURKE KNAPP, PORTOLA VALLEY, CA

Mr. KNAPP. With your permission, Mr. Chairman, I would like to start with a prepared statement and then, if time permits, supplement it with comments arising out of recent events out of Seoul.

Senator MATHIAS. I understand the need to update any written statement. When I commented a day or two ago to Paul Volker that I was coming here to these hearings, he said why don't you wait a week, it will all be different.

So you have the floor.

Mr. KNAPP. My name is J. Burke Knapp. I am a self-employed international financial consultant, resident in Portola Valley, CA.

But I suppose I appear here because I retired as a Senior Vice President of the World Bank in 1978, having served for 20 years as the Chairman of the Loan Committee of the World Bank and the International Development Association.

Senator MATHIAS. Mr. Knapp, let me say that, because we are dealing with a moving target, that if you wish to summarize your statement so that you can include the current remarks, your full statement will appear as it is written as if you had read it. And you can have a little more flexibility in dealing with your remarks.

Mr. KNAPP. Very good. I will keep it short.

One conclusion that clearly has arisen from all the discussion which has taken place so far in this forum is that Third World debt problems can only be resolved within a framework of economic growth—growth in the world economy and growth also in the individual debtor countries.

And I also think that clearly the conclusion emerges from these discussions that such growth is in the economic, political, security interests of the United States. And that indeed those interests of the United States will lend urgency to finding a solution to these problems.

Growth in the developing countries is and must remain first of all the responsibility of those countries themselves. There can be no external substitute for domestic policies and programs conducive to economic development.

But there is a key role—even an indispensable role, in my judgment—for what I would call development banking. That is to say the systematic provision of financial and technical assistance focused upon the development of productive facilities, and supplied on financial terms geared to the nature of the investment being undertaken as well as to the pace of the general economic development of the country concerned.

I think it very fortunate that there are in place several major international institutions with long and deep experience in this kind of development banking. And I refer to the World Bank Group and to the principal regional banks organized along similar lines, the Inter-American Development Bank, the Asian Development Bank and the African Development Bank.

All of these institutions mobilize broad international support from the developed countries in providing the financial and technical resources that are the essential external ingredients for economic development. They also enjoy the requisite confidence and respect of the developing countries whom they serve.

In a real sense, the most fundamental task of these multilateral development banks is to provide advice and guidance to their borrowing member countries regarding the efficient design and execution of their development programs and policies.

And I would illustrate the spirit in which these institutions approach that task by quoting from a recent World Bank document in which the basic principles of how to help these countries carry out effective development programs is summarized as follows.

The advice from the World Bank is:

"Be wary of comprehensive, long-term plans which rely on over-sophisticated forecasting exercises."

The success stories of postwar economic development followed a different strategy: framework of macroeconomic policies to spur economic growth and elicit desired behavior from both public and private entities.

It goes on to say:

> Let the marketplace do its job whenever possible. Reasonably efficient and responsive Government leadership is critical to successful development, and there are many services that Government alone can provide.
>
> But the legitimate demands on the public sector are very large, while the capacity for public management is among the scarcest of development resources. This capacity should therefore be devoted to those activities where it is most needed and most likely to be efficacious.

I am reading these because you hear a lot in some public discussions about the so-called socialist orientation of the World Bank and how it has been fostering governments and government enterprises and all the rest of it.

Senator **Mathias**. We hear a good deal of that in Congress.

Mr. **Knapp**. Yes, all right. This is the experience of the World Bank out of the World Bank's own record and that they now put forward as their point of view. And you won't find there that which is alleged in some of the descriptions of the bank.

Now, in order to be adequately equipped for this challenging advisory role—and this is advising on development and advising on development programs and policies—these multilateral institutions have builtup staffs of economists, engineers, management experts, et ceters, who have unrivalled expertise in both the macroeconomic administration of development programs as well as the microeconomic execution of specific development projects.

It is a commonplace in these institutions to say that these staffs perform at least as important a function as those who carry out the actual borrowing and lending operations that characterize a development bank.

But if the first task of a development bank lies in the provision of advisory and technical assistance, its true raison d'etre resides in its financial role as an intermediary between the prime sources of development finance—that is, the capital markets of the world in the case of the Bank, and in the case of IDA, the Governments of the world—intermediary between those sources and the financial requirements arising out of investment in development.

The case for enabling such institutions to mobilize extensive financial resources for deployment in the developing countries may be put briefly as follows:

Growth and development of these countries requires heavy investment.

Countries at their level of per capita income cannot reasonably be expected to mobilize domestic savings sufficient for this purpose.

In particular, foreign exchange resources in such countries are characteristically scarce.

Other sources of foreign exchange are lagging. Programs for the poorest countries are suffering from budgetary pressures in the rich countries—look at the situation in IDA—and new commercial bank financing for the more advanced developing countries has drastically declined.

There is a pressing requirement for long-term foreign exchange loans with extended periods of grace, reflecting the long gestation of period of development projects and the even longer period required to lift underdeveloped economies to adequate levels of domestic income and savings. The multilateral development banks are uniquely equipped to provide development financing of this kind.

These institutions are also uniquely qualified to act as catalytic agents in promoting other capital flows from public and private sources into investment in top-priority economic development projects. The mobilization of cofinancing from commercial banks for projects vetted and supervised by the development banks offers but one example of this function.

Finally, the World Bank in particular is also fulfilling—here I mean the World Bank as contrasted with the regional institutions—is also fulfilling an invaluable role on behalf of the entire international community not only in helping its poorer member countries to design efficacious development programs and policies, but also in establishing and monitoring the standards of performance for borrowing countries in these fields, all in order to help assure that development assistance is used to sustain "those that help themselves."

The World Bank's influence and authority in this field is very much dependent upon its own ability to followup on its recommendations and judgments with important financial commitments to those countries that respond effectively.

This is not the place to set forth the specific financial requirements of the multilateral development banks, each of which will from time to time be presenting its case for replenishment of its resources.

It may be recalled, however, that each of them has its ordinary banking operations financed primarily by the sale of bonds in the international capital markets. And then also its special funds for loan to the poorest countries on concessional terms, financed by periodic contributions from the more advanced countries.

In order to expand their original lending operations—that is, their banking operations proper—what these institutions mainly require from their sponsoring governments, including the United States, is only certain additional guarantees taking the form of capital subscriptions with a very small paid-in component.

Only in the case of concessional funds are substantial appropriated sums required, and even these will be called for actual disbursement by the contributing governments only over a long period of years after they are voted.

I would like then to enter into the record a paragraph or two about IDA, which I am a very strong believer in. I know you are too, Senator. And I won't take the time here because it is not that category of countries that we are focusing on.

But for all the importance that should be accorded to the needs of the poorest developing countries, the fact is that the agenda for these hearings is focused primarily on the problems of the more advanced developing countries.

It is the massive borrowings of these countries from the commercial banks that have created the current debt crisis. And it is in these countries that the high-growth/low-growth alternatives will have the greatest impact upon the world economy, upon the international trade and investment activities of the United States, and more generally upon this country's economic, political, and security interests.

With regard to these regular operations, I would like to emphasize three points.

One, these operations are to a remarkable extent financially self-supporting. They are funded primarily out of the private international capital markets. They are very prudently administered. They are not subject to debt rescheduling and losses have been negligible.

And they have earned very substantial profits which have gone to fortify the resources of the institutions. The net income of the World Bank alone has run at over $500 million a year for several years, and exceeded $1 billion in its fiscal year ending last June.

It remains true, however, that the credit-worthiness of these institutions in the world capital markets depends in part upon the capital subscriptions made to them by the principal member governments.

For legal as well as financial reasons, the banks cannot expand their regular operations to meet the new requirements without the injection of fresh capital. It is recalled once more, however, that for the most part these capital subscriptions represent a paper exercise. Only relatively minor sums actually have to be paid in.

I allude once more to the need, now more pressing than ever before because of the present external debt patterns, for longer maturities and longer grace periods on loans extended by the multilateral development banks. And for that matter, by other banks.

It was the inappropriately short maturities of commercial bank financing that were a key factor in precipitating the recent debt crisis. The rash of rescheduling of these obligations represents a retroactive readjustment to economic reality.

The development banks, relying for their funds primarily upon their long-term bond issues rather than upon deposits and short-term interbank borrowings as in the case of commercial banks, have always made longer term loans, say, for 15-20 years with a period of grace of 4 or 5 years.

But they ought now to be stretching further, especially in order to avoid imposing new financial obligations during the critical decade ahead when the borrowing countries will be struggling to generate new growth and repayment capacity.

And they ought, in arranging cofinancing with other institutions offering relatively short-term credit, for example, commercial banks, to cede the shorter maturities on amortized loans to their cofinancing partners while accepting the later maturities for themselves.

They should also be encouraged to use their guarantee and take-out powers to induce commercial banks to extend terms of their own loans. The World Bank has recently been experimenting along these lines.

However, there is a catch. Again, for legal and financial reasons, there is a direct relationship between capital requirements and the duration, as well as the amount, of new loan commitments by the development banks.

Longer maturities and grace periods naturally lead to higher levels of exposure in future years. Hence the development banks will require additional capital subscriptions not only to expand the volume of their loan commitments but also to lengthen their maturities.

In the mid-1970's, in order to economize upon its requests for additional capital subscriptions, the World Bank actually took actions to shorten maturities and grace periods on its new loans. This was a retrograde step which should now be reversed and replaced by a move in the opposite direction.

In the present context, special mention should be made of another affiliate of the World Bank, the International Finance Corporation. This corporation provides venture capital in both loan and equity form to foster the growth of private productive enterprises in developing countries around the world.

Although its own investment activities are modest by comparison with the World Bank—new commitments of $900 million in the year to last June 30 as compared to $11 billion for the World Bank—it mobilizes many times that amount of cofinancing from other foreign investors and from domestic investors in the country concerned.

It has recently received substantial new capital subscriptions from its principal member countries, including the United States, in recognition of its outstanding success in promoting more active and productive private sectors in the economics of the developing countries.

I conclude my statement here by expressing the fervent hope that you, sir, and the other members of the subcommittee will join in providing strong bipartisan encouragement and support to properly documented and justified requests that may come from the multilateral development banks.

And I interrupt that to say, Mr. Chairman, that I very much hope that even though you may be laying down your burdens of office, that you will have a whack at a few of these problems before you leave.

It should be recalled that it was the United States that took the lead in foundling and sustaining these institutions in the decades following World War II.

It is time for this country to reappraise the tremendous stake that it has in the peaceful and orderly growth of the world economy, and the critically important role that the multilateral development banks are capable of playing in bringing the developing countries fully into this process.

It is my view that if these banks did not now exist for this purpose, they would have to be invented.

Sir, may I then follow with a few supplementary remarks?

[Mr. Knapp's prepared statement follows:]

PREPARED STATEMENT OF J. BURKE KNAPP

My name is J. Burke Knapp. I am a self-employed international financial consultant, resident in Portola Valley, California. I retired as the Senior Vice-President of the World Bank in 1978, having served for twenty years as the Chairman of the Loan Committee of the World Bank and the International Development Association (IDA).

One conclusion has surely emerged from the highly impressive body of analyses and opinions that has been presented during the course of these hearings, namely that the Third World debt problems can only be resolved within a framework of economic growth - growth in the world economy, and growth also in the individual debtor countries. You will also have been convinced, I am sure, that in this inter-dependent world an evolution along these lines will strongly support the economic, political, and security interests of the United States.

The responsibility for fostering growth and development in the debtor countries is a task that falls primarily upon those countries themselves. There can be no external substitute for domestic policies and programs conducive to economic development. But there is a key role - even an indispensable role - for development banking, which I shall define as the systematic provision of financial and technical assistance focussed upon the development of productive facilities, and supplied on financial terms geared to the nature of the investment being undertaken as well as to the pace of the general economic development of the country concerned. Very fortunately there are in place several major international institutions with long and deep experience in development banking. I refer primarily to the World Bank Group and to the principal regional banks organized along similar lines: the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank. All of these institutions mobilize broad international support from the developed countries in providing the financial and technical resources that are the essential external ingredients for economic development. They also enjoy the requisite confidence and respect of the developing countries whom they serve.

In a real sense the most fundamental task of these multilateral development banks is to provide advice and guidance to their borrowing member countries regarding the efficient design and execution of their development programs and policies. To illustrate the spirit in which these institutions approach that task, I cite the following quotation from an official World Bank summary of a book recently published under its sponsorship, entitled "Investing in Development - Lessons of World Bank Experience" by Messrs. Warren C. Baum and Stokes Tolbert.

"Be wary of comprehensive, long-term plans which rely on overly-sophisticated forecasting exercises and seek to target inputs and outputs for all sectors of the economy. The success stories of postwar economic development come from those countries that have followed a strategy focussed on two elements: a framework of macroeconomic policies to spur economic growth and elicit desired behavior from both public and private entities, and an investment program for the public sector that allocates scarce resources to high priority public needs.

-- Let the market place do its job whenever possible. Reasonably efficient and responsive government leadership is critical to successful development, and there are many services that government alone can provide. But the legitimate demands on the public sector are very large, while the capacity for public management is among the scarcest of development resources. This capacity should, therefore, be devoted to those activities where it is most needed and most likely to be efficacious.

-- Create a positive policy environment, particulary on pricing policies. Prices play a key role in allocating resources efficiently, and can be used to promote social objectives - such as poverty alleviation - and to raise more public revenues.

-- Pay attention to the human dimension. ....Projects are managed by people, and there is a close correlation between good managers and good projects. Conversely, management problems - in the form of weak public administration, weak management at the enterprise level, and inadequately trained staff - are the most pervasive source of difficulties in project implementation."

In order to be adequately equipped for this challenging advisory role, these institutions have built up staffs of economists, engineers, management experts, etc. who have unrivalled expertise in both the macro-economic administration of development programs as well as the micro-economic execution of specific development projects. It is a commonplace in these institutions to say that these staffs perform at least as important a function as those that carry out the actual borrowing and lending operations that characterize a development bank.

But if the first task of a development bank lies in the provision of advisory and technical assistance, its true raison d'etre resides in its financial role as an intermediary between the prime sources of development finance and the financial requirements arising out of investments in development. The case for enabling such institutions to mobilize extensive financial resources for deployment in the developing countries may be put briefly as follows:

1. Growth and development of these countries requires heavy investment.

2. Countries at their level of per capita income cannot reasonably be expected to mobilize domestic savings sufficient for this purpose.

3. In particular, foreign exchange resources in such countries are characteristically scarce, especially under present conditions of low prices for their commodity exports and high interest rates on their swollen external debts.

4. Other sources of foreign exchange financing are lagging. Programs for the poorest countries are suffering from budgetary pressures in the rich countries, and new commercial bank financing for the more advanced developing countries has drastically declined.

5. There is a pressing requirement for long-term loans with extended period of grace, reflecting the long gestation period of development projects and the even longer period required to lift under-developed economies to adequate levels of domestic income and savings. The multi-lateral development banks are uniquely equipped to provide development financing of this kind.

6. These institutions are also uniquely qualified, in both their technical and financial roles, to act as catalytic agents in promoting other capital flows from public and private sources into investment in top-priority economic

development projects. The mobilization of co-financing from commercial banks for projects vetted and supervised by the development banks offers but one example of this function.

7. Finally, the World Bank, in particular, is also fulfilling an invaluable role on behalf of the entire international community not only in helping its poorer member countries to design efficacious development programs and policies, but also in establishing and monitoring the standards of performance for borrowing countries in these fields - all in order to help assure that development assistance is used to sustain "those that help themselves". The World Bank's influence and authority in this field is very much dependent upon its own ability to follow up on its recommendations and judgements with important financial commitments to those developing countries that respond effectively.

This is not the place to set forth the specific financial requirements of the multi-lateral development banks, each of which will from time to time be presenting its case for replenishment of its resources. It may be recalled however, that each of them has its ordinary banking operations, financed primarily by the sale of bonds in the international capital markets; and its special fund for loans to the poorest countries on concessional terms, financed by periodic contribution from the more advanced countries. In order to expand their ordinary lending operations, what these institutions mainly require from their sponsoring governments, including the United States, is only certain additional guarantees, taking the form of capital subscriptions with a very small paid-in component. Only in the case of their concessional funds are substantial appropriated sums required, and even these will be called for actual disbursement by the contributing governments only over a long period of years after they are voted.

From my years of experience in the promotion of economic development around the world, I see a compelling case for the United States to give far higher priority, within whatever overall budgetary limitations it must impose, to the needs of the multilateral concessionary funds. Among other things such action would trigger a multiple increment to the resources of these funds. In the case, for example, of the World Bank's International Development Association, or IDA, other country contributors match the United States three to one in their donations, and most of them have consistently pressed the United States in recent years toward higher levels of IDA replenishments, than this country has found acceptable. Expressed differently, the United States has been put in the unenviable position that for every dollar that it cuts from IDA appropriations, the poorest countries have been threatened with the loss of four dollars. The fact that some IDA contributors have on some occasions persisted in making supplementary donations despite the refusal of the United States to go along, merely emphasizes this country's isolation on this issue.

But for all the importance that should be accorded to the needs of the poorest developing countries, the fact is that the agenda for these hearings is focussed primarily on the problems of the more advanced developing countries, which receive their support from the regular operations of the World Bank and the regional development institutions. It is the massive borrowings of these countries from the commercial banks that have created the current "debt crisis", and it is in these countries that the high growth/low growth alternatives will have the greatest impact upon the world economy, upon the international trade and investment activities of the United States, and more generally upon this country's economic, political, and security interests.

With regard to these regular operations, I would like to emphasize three points:

1. These operations are, to a remarkable extent, financially self-supporting. They are funded primarily out of the private international capital markets. They are very prudently administered. They are not subject to debt rescheduling, and losses have been negligible. And they have earned very substantial profits which have gone to fortify the resources of the institutions. The net income of the World Bank alone has run at over $500 million a year for several years, and exceeded $1 billion in its fiscal year ending last June.

It remains true however, that the creditworthiness of these institutions in the world capital markets depends in part upon the capital subscriptions made to them by the principal member governments. For legal as well as financial reasons, the banks cannot expand their regular operations to meet the new requirements without the injection of fresh capital. It is recalled once more, however, that for the most part these capital subscriptions represent a paper exercise - only relatively minor sums have to be actually paid in.

2. I allude once more to the need, now more pressing than ever before because of the present external debt patterns, for longer maturities and grace periods on loans extended by the multilateral development banks. It was the inappropriately short maturities of commercial bank financing that were a key factor in precipitating the recent "debt crisis"; the rash of rescheduling of these obligations represents a retro-active readjustment to economic reality. The development banks, relying for their funds primarily upon upon their long-term bond issues rather than upon deposits and short-term inter-bank borrowings as in the case of the commercial banks, have always made longer term loans - say for 15-20 years with 4 or 5 years period of grace. But they ought now to be stretching further, especially in order to avoid imposing new financial obligations during the critical decade ahead when the borrowing countries will be struggling to generate new growth and repayment capacity. And they ought, in arranging co-financing with other institutions offering relatively short-term credit- e.g. commercial banks - to cede the shorter maturities on

amortized loans to their co-financing partners while accepting the later maturities for themselves. They should also be encouraged to use their guarantee and take-out powers to induce commerical banks to extend the terms of their own loans; the World Bank has recently been experimenting along these lines.

However, there is a catch. Again for legal and financial reasons, there is a direct relationship between capital requirements and the duration, as well as the amount, of new loan commitments by the development banks. Longer maturities and grace periods naturally lead to higher levels of exposure in future years. Hence the development banks will require additional capital subscriptions not only to expand the volume of their loan commitments but also to lengthen their maturities. In the mid-1970's, in order to "economize" upon its requests for additional capital subscriptions, the World Bank actually took actions to shorten maturities and grace periods on its new loans. This was a retrograde step which should now be reversed and replaced by a move in the opposite direction.

3. In the present context, special mention should be made of another affiliate of the World Bank, The International Finance Corporation. This Corporation provides venture capital, in both loan and equity form, to foster the growth of private productive enterprises in developing countries around the world. Although its own investment activities are modest by comparison with the World Bank

(new commitments of $900 million in the year to last June 30 as compared to $11 billion for the World Bank), it mobilizes many times that amount of co-financing from other foreign investors and from domestic investors in the country concerned. It has recently received substantial new capital subscriptions from its principal member countries, including the United States, in recognition of its outstanding success in promoting more active and productive private sectors in the economies of the developing countries.

I conclude by expressing the fervent hope that the members of this Sub-committee will join in providing strong bipartisan encouragement and support to properly documented and justified requests that may come from the multilateral development banks. It should be recalled that it was the United States that took the lead in founding and sustaining these institutions in the decades following World War II. Yet in recent years, beset by budgetary difficulties at home and losing sight perhaps of its real priorities abroad, the United States has allowed its support to weaken. It is time for this country to reappraise the tremendous stake that it has in the peaceful and orderly growth of the world economy, and the critically important role that the multi-lateral development banks are capable of playing in bringing the developing countries fully into this process. If these banks did not now exist for this purpose, they would have had to be invented!

Please accept my very best thanks for permitting me to make this contribution to your deliberations.

Senator **Mathias**. By all means.

Mr. **Knapp**. The subject of this panel might be read to include the affairs of the IMF. I have not discussed it in any detail. Originally, Bill Bolin was going to talk about it and he was unable to come.

I only want to say with respect to the IMF, that it is obvious I think that it has a very key role in the debt rescheduling exercises and in the solution of the debt problem and I feel has performed this role with great competence, with great seriousness of purpose, and with great concern at not imposing undue burdens upon the developing countries.

I don't have much sympathy with the attacks on the Fund because they have been insisting upon austerity. You do need to have a period of stopping the rot. Because many of these countries were on a downhill slope where had not somebody intervened to stop the rot they would have been in far deeper trouble than they are.

Nonetheless, the Fund having accomplished that function is not equipped, and is the first to say they are not equipped, to finance growth and long-term development. Their funds are not suitable for that purpose. They have got to conserve their funds and restore them to this revolving pool that they operate in order to meet future situations.

And they don't have the expertise in fostering new development programs. So I have been much impressed by the new U.S. initiative of Seoul. And I think the elements of it that have been emphasized are all positive and achievable.

The reliance upon the World Bank and the other multilateral institutions, you will have gathered from my statement, I am in favor of that. I think that that is sound and I think the Bank, given this new vote of confidence, can pull its act together and take the leadership in many of these aspects.

But it will need the capital increase, and it will need it soon. And I am hoping from some of the things I have seen in the press that Baker is saying, I can't make a commitment now because to do so I need to consult with Congress and I need to get back home to do that. And it won't be until next year that we will have gone through there consultative arrangements.

At least I am taking the opportunity to say that is what ought to be in the back of his mind. But he can't call upon the World Bank to carry out a lot of the responsibilities that have been described, as I have been describing briefly, and at the same time to deny them the additional capital resources that are required for that purpose.

Now, as far as the commercial banks are concerned, my own view is that the $20 billion figure for supplementary additional commitments by commercial banks is a very modest figure. Very modest in relation to all past experience.

And let me say, we are inclined to get sort of ethnocentric here. That is a world figure. That is not U.S. banks, that is a world figure. And the Japanese banks, the German banks, the European banks generally, not to mention others—the Arab banks—that are in a position to make some contribution to this.

I think we should not look upon this as bankbashing. I mean, there is one point of view that says the banks have made a terrible mess here and it is up to them to pull us out of the situation and we will put the screws on them.

That is not the way I look at it. I don't think that is the way Baker looks at it. I think the way Baker looks at it is the same way a bank looks at a domestic situation where they made a loan and the fellow has got in trouble and he is going to need some rescheduling. And, by golly, if he is really going to get his business running he needs some new credit. And the new credit will pay for itself and pull him out.

That is the way I would look at this. And I do believe that new money is needed to accomplish recovery and the initiation of new growth in these countries. I don't think it all can come from public sources.

And it is not money that is going to be—you know, the phrase throw good money after bad. Well, in the first place it shouldn't be thrown. In fact, some of the past money was kind of thrown.

This should be directed to purposeful investment in productive activity in which the yield in terms of output and growth and the yield in terms of balance of payments, either production of exports or, very importantly, conservation of imports—that this investment will pay for itself across the balance of payments and make a net contribution indeed to the servicing of the old debt.

I believe that such projects exist in developing countries. It is the business of the Bank and the IFC among other things to find those projects and to invite the commercial banks into cofinancing.

I think their risks on the new lending will be much diminished because it is purposeful and directed as compared with the old days where it was much less purposeful. And I myself would strongly encourage the banks to accept this modest role.

Now, yes, the LDC's themselves. The developing countries themselves have a lot of their plate. And I started by saying that. The first condition of getting growth and getting them out of the hole of this external debt problem is to get their own houses in order and get programs and policies conducive to economic growth.

And in general, I think that the things that Secretary Baker has emphasized—I haven't seen his speech but I understand it had to do with promoting the role of private enterprise and less reliance upon public enterprises, even disposition and privatization of public enterprises, generally running the economy on sound lines in terms of budgets—not taking any lessons from the United States in that respect—getting their fiscal houses in order. These are all things they are going to have to do.

We—parenthetically—we in the United States can afford to go on our splurge for a while. We are coming to the end of that while. But these developing countries can't. And they realize that. They know they have got to get their own houses in order.

And I think in most of the leading cases in Latin America, we can have reasonable confidence that they will do so.

Now, I do think that when it comes to the United States or the international institutions negotiating—that is what it is, it is going to be a negotiation with these countries—I do think that some moderation has to be exercised in pushing some of our points of view.

Let's face it, the world out there and many of these countries are not as committed to a capitalistic free enterprise type of system, as we think they ought to be. And they are not going to be bludgeoned into it. They are going to be persuaded into it.

And one of the ways to persuade them is to show them examples—East Asia. But some moderation must be exercised, some give and take. And it is not going to be accomplished overnight.

And if we do overplay our hand and try to press them into measures for which they are not yet ready, it will give strength in their own countries to the opposition, to the resistance elements and Philip Habib gave you some picture of what that means.

We have got to let the leaders of these countries tackle these problems to some extent at their own pace.

Now, I guess I have said enough about the importance of growth, but let me just key in again on that word. The need is to raise the standards of living in these countries in the first instance, and to cope with population growth. That is going to be essential to their social and political stability.

But also growth obviously is a way to grow out of their present debt. The potential is there. The LDC record on growth is extraordinary. I mean, here in the United States we are fumbling around with a question of whether we are going to do 2 percent or a 3 percent growth.

In the LDC's generally, and in the Latin American countries we are talking about, growth of 5, 6, 7 percent per annum is the standard. They will get back to it, if they are given a chance, and if some of their immediate financial problems are resolved.

On the projects, there are all kinds of projects lying around that can accomplish the purpose of what we are talking about. Just think of the projects in food production, or in energy. I mention those particularly because they would conserve on imports and conserve on the balance of payments without producing new exports.

But there will also have to be export projects. And when we come to the export projects, I must weigh in and say I agree with everything that has been said about the importance of keeping markets open to the products of these countries.

Professor McKinnon made one remark I just want to quickly comment on which was that he thought maybe the World Bank ought to turn into a refinancing institution and refinance some of the old debts and get them on a long term.

Well, I think you will see from what I am saying that I think that would be a great mistake. Because it is exactly in the development of new projects and new productive methods of investment that the World Bank and its affiliates and the other international institutions can be very effective.

If they were turned into mere refinancing agencies, you would lose that.

And finally, sir, a good deal has been said, particularly by Philip Habib—and everybody was agreeing with him—that it is not just a U.S. problem. It is a world problem. And that other countries ought to collaborate in the solution.

And I agree with that absolutely and call your attention to the fact that in these multilateral institutions you have a ready-made mechanism for burdensharing. Because the share of the United States in IDA, for example, is about 25 percent. And its share of capital in the World Bank is about 20 percent.

And the rest of the world has stood ready for years, waiting upon the United States, and has said they will follow the U.S. lead. In the case of IDA, as you know, sir, the whole thing was brought down and down to the lowest common denominator, which was the United States. The other countries were quite prepared to put in substantial additional resources to match the United States

And I feel confident the same thing is true of the World Bank. I think the increase—the necessary increase in capital of the World Bank can be assured at any moment that the United States decides to face up to the magnitude of the problem. The rest of the countries will be quite ready to go along.

And if anybody doubts that, I will bet a billion dollars on it with anybody in the room.

Senator **Mathias**. You are out of my league. Not that I would want to take the bet under any circumstances.

First of all, let me respond to your expression of hope that the members of this subcommittee will join in providing strong bipartisan encouragement and support for the multilateral development banks.

As you already know, that strikes a very responsive chord with me personally.

Mr. **Knapp**. Yes.

Senator **Mathias**. But beyond myself, I am happy to say that I think there is a strong feeling within this subcommittee and within the foreign relations committee in support of multinational banks.

And with the help of Senator Danforth, who is not a member of the committee, we were able to expand the authorization beyond the administration request. Now that was not cash, and of course it is cash that counts. But at least it is the road to cash with the expanded authorization.

So those are all encouraging signs. And I am happy that Jim Baker made his statement at Seoul and that he has done it in time for me to personally participate in carrying out and executing that plan while I am still wearing the toga. Because that is a project in which I have great personal interest.

But having said all that, let me say that there are a lot of currents that are moving against us. I think there is an aspect of the protectionist wave which will rub off on the multilateral developments banks. There will be an argument made that we are financing our competition, that we are digging our own grave, and that we will have to stop it.

And that will be a powerful argument in the present climate. And I only point that out, not to cast a pessimistic note on these proceedings, but to say that realistically it has to be countered. Those arguments have to be met and overcome.

And that is one of the purposes that we are here in San Francisco holding these hearings to do. Because unless the basis of information is available, those arguments will prevail.

It is a dangerous situation, and one that we have to constantly work against.

Now, while we are talking about supporting the needs and demands of the multilateral development institutions I am wondering if you could tell us what the World Bank would do by way of extending additional credit against the current capital base?

Would there have to be some changes in the current lending practices that would be required? And would this have implications of requiring some fundamental constitutional change in the Bank, that someone would have to take the initiative to bring about?

I suppose the short question is, how can the Bank leverage its own operation?

Mr. **Knapp**. Right, right. The short answer to that is, that given the capital structure and the flow of funds in the Bank, the flow of its borrowings, the flow of its disbursements and long-term loans—you can figure out that the bank could sustain a level of new loan commitments at about, say, $13 billion to $14 billion. In other words, more or less the present level. Some modest increase in the present level, but very small, but with its present capital structure.

But if it ventures into a higher lending rate than that, it runs into trouble. It needs additional capital subscriptions to sustain a higher rate of lending. And the hope is, of course, that it can raise its new lending commitments to higher levels.

And I also emphasize the need for lengthening the term of these loans. And that too requires higher capital subscriptions.

There have been talks sometimes of structural changes so that you could increase the leverage—you used the word leverage—of the Bank's loans against the capital. But this would require changing the Articles of the Bank and runs the danger that the Bank's own creditworthiness would be threatened. The concern is that a higher gearing of the Bank's lending operations vis-a-vis its capital would diminish the attractiveness of its own bonds.

It would have to pay, in the first place, higher interest rates, or indeed might come to the point where its creditworthiness in the capital markets would be threatened.

All of this can be avoided by the voting of new capital resources from the principal member countries very largely not as cash contributions but as unpaid capital subscriptions, providing a sort of guarantee fund. I think you are familiar with that, sir.

Senator **Mathias**. Peter.

Mr. **Jones**. A vice president of the World Bank told some of us on the Bretton Woods Committee the other day that there was one precedent in 1979 where there was some increase temporarily in World Bank lending in anticipation of a general capital increase.

Therefore in the short term, if there was again a signal from the administration that in due course there would be support for a general capital increase, that might give the Bank room to move up to $15, $16, $17 billion lending a year.

Is that right?

Mr. **Knapp**. Right; you can run it up temporarily. I was talking about the long-term sustained level. You can run up to $15 or $16 billion at the cost of having to retreat to $9 or $10 billion——

Mr. **Jones**. Yes.

Mr. **Knapp** [continuing]. Three years later if you don't get the capital increase. So how much of a gamble should the Bank be asked to take? I don't think that is a fair thing to ask of an institution.

Mr. **Jones**. Without some indication from the administration that it is supported.

Mr. **Knapp**. Yes.

Senator **Mathias**. It would have to be a pretty firm indication.

Mr. **Jones**. Yes, it would.

Senator **Mathias**. And—I hate to add this—but somebody would have had to have counted heads in Congress.

Mr. **Jones**. That's right.

Senator **Mathias**. That cannot be taken as an automatic response.

Mr. **Knapp**. I think it is pretty risky.

Mr. **Jones**. That is a judgment that the Bank will have to make.

Senator **Mathias**. Well, I think it is doable. But I think as far as Congress is concerned, I think some action is doable. But I think there will have to be very vigorous support from the President personally, and from the administration generally.

Now, in Seoul, Secretary Baker called for a more vigorous World Bank role in the world debt crisis. One of the criticisms of the Bank that we hear in the Congress is with respect to the Bank's ability to react quickly to loan needs, to move with rapidity.

What comment would you have on those criticisms?

Mr. **Knapp**. Well, in the first place, I think the criticism is true. That compared to other agencies like, for example, the Monetary Fund or indeed commercial banks, the World Bank is slow to move.

But why is it slow to move? It is slow to move because its lending is purposeful and directed and seeking out productive investment in productive projects. And that takes time.

It takes time to do that, to appraise the projects, and it takes time to negotiate with the recipient country or agency the conditions necessary to make that a productive project.

So, I think the time spent in that appraisal and in that negotiation is worthwhile. Some of the troubles about past lending has been it has been too quick.

Senator **Mathias**. Another criticism is the Bank ought to move away from project lending and go further in the direction of structural adjustment lending.

Mr. **Knapp**. Right.

Senator **Mathias**. I suppose in a sense it is to fill that historic gap that exists between the World Bank and the IMF.

Mr **Knapp**. Right. First of all, I want to say that I am in favor of structural adjustment lending in some proportion. Maybe around the present 10–15 percent is something like the right proportion.

I wouldn't myself think one should go for much more. And let me explain why. The two arguments for structural adjustment lending are, first, more rapid disbursement. And that touches on the point you are raising. That is another reason why World Bank money is slow to move in because projects take a long time to disburse. Whereas if you do a structural adjustment loan, you can disburse pretty quickly.

So, that is an advantage of structural adjustment lending. And indeed I guess that is the main reason why I think it is useful to have that instrument in the World Bank in at least a modest amount.

The other argument, however, is that you ought to make a structural adjustment loan in order to be able to negotiate conditions with the country with respect to their macroeconomic and their development performance.

And, indeed, a structural adjustment loan is just that. A country is going to change its structure of operations and move on to a more productive base and you negotiate conditions.

Well, that's fine. But my response to that is, if the World Bank is lending say a billion dollars a year, as they have been to Brazil, on projects, doesn't that establish a bargaining position under which you can negotiate for appropriate action by Brazil?

I think it does. And the Bank has always done that. I will admit that a structural adjustment loan gives you a little more handle and perhaps a little more acceptance by the recipient country that such conditions are justified.

But I don't have any difficulty myself in justifying such conditions on a pure project lending program, if only because the conditions we are talking about are helping to shore up the creditworthiness of the country. Why should we be lending a billion dollars a year to Brazil unless they are pursuing policies which will sustain their creditworthiness for that kind of lending.

The short answer is, I guess, that the World Bank should have that instrument, but I think it should use it somewhat carefully.

Senator **MATHIAS**. What is your position on this question of whether or not we need something between the World Bank and the IMF?

Mr. **KNAPP**. Oh, between—yes, between the Bank and——

Senator **MATHIAS**. Or do you think each can overlap enough that——

Mr. **KNAPP**. Well, I think the problem may be overlapping rather than having something in the middle. I think the problem is better coordination between the Fund and the Bank.

Senator **MATHIAS**. But we don't need some new financial——

Mr. **KNAPP**. I would think certainly not.

Senator **MATHIAS**. Now, in your prepared statement, you comment on the profits that the Bank has earned. You say they have earned very substantial profits which have gone to fortify the resources of the institutions. The net income of the World Bank alone has run at over $500 million a year for several years, and exceeded $1 billion in its fiscal year ending last June.

This has been cited as a source of embarrassment in the press. Do you feel embarrassed?

Mr. **KNAPP**. Not at all. Why should I feel embarrassed? I'll tell you, the only reason I can think of that we would feel embarrassed is that the developing countries might say, my gosh, you made all these profits off of us, and that means your interest rate to us is too high, and you ought to reduce the interest rate.

Senator **MATHIAS**. You are feeding off the poor and needy.

Mr. **KNAPP**. Yes. One of the answers to that is that a lot of these profits have been made not out of lending to the developing countries and the interest returned from the Bank's loans outstanding, but rather from the management of Bank's liquid assets.

And this is quite a trick that there isn't time to discuss here, but just bear in mind the World Bank has about $15 billion at the present time in purely liquid assets awaiting disbursement against loan commitments. And they have made a really magnificant play with those funds and have invested them very profitably and earned a lot of money off of that $15 billion pool of liquid funds.

Senator **Mathias**. Well——

Mr. **Knapp**. No, I am not embarrassed.

Senator **Mathias** [continuing]. The explanation is important though, because this is an area of criticism of the Bank.

Mr. **Knapp**. Well. mind you, this liquid fund is a partial explanation. The Bank is also making money on its lending operations. But I don't know why we should be embarrassed about it.

As a matter of fact, it all comes back to help support the work of the Bank. It relieves the contributors, the U.S. Government and others, from capital subscriptions. This money we're earning goes into the Bank and is just as good as a capital subscription, or rather better from the point of view of the Bank.

So I don't. I am not embarrassed.

Senator **Mathias**. Could you analogize it to several low-income housing projects that are now working in the private sector in this country where urban area is brought up, rehabilitated, sometimes with the sweat equity of people who live in the area, and then rolled over and some modest profits made, which in turn then gets reinvested in a slightly larger area which then gets rehabilitated?

Would you say it is the same principle?

Mr. **Knapp**. I mean, I would be a little embarrassed maybe if this was a private enterprise and all this money was flowing into somebody's pocket. But it is not. It is being retained to fortify the resources of the institution in its task of helping developing countries.

Senator **Mathias**. To what extent does the World Bank require the borrowing country to provide counterpart funding as a condition of the World Bank loans?

Mr. **Knapp**. In very case. It never finances 100 percent of a project cost. In every case there are funds provided locally. There is some argument sometimes about how the ratio should be.

Senator **Mathias**. It is a flexible ratio?

Mr. **Knapp**. Very flexible. Depending upon the nature of the country and the nature of the project. Depending particularly on the nature of the country and their capacity to mobilize funds themselves.

But there is always a counterpart. And in fact the average is substantially under 50 percent that is financed by the World Bank. Normally, the larger share will be taken by the mobilization of domestic funds.

Senator **Mathias**. In your experience, has this been an impediment to World Bank lending?

Mr. **Knapp**. Well, I think perhaps the question touches on this issue.

Senator **Mathias**. Does it? I suppose I should go further and say, is it an impediment in those cases that may need the help of the World Bank the most?

Mr. **Knapp**. Well, I think at the present time it has been found that some projects have had to be postponed in developing countries just because they were unable to mobilize in present circumstances adequate amounts of local funds.

And in such a case, you have to look at it on its merits. But in such a case, I believe it has been the policy of the World Bank in some of these especially debt-ridden countries to increase the proportion of its participation in order to relieve the demand on the local resources.

So, I think again that is a matter which should be approached flexibly.

Senator **Mathias**. Professor Fishlow, you have been very quiet for the last few minutes. Do you have any final comments to make?

Mr. **Fishlow**. Well, I think the lesson from the whole set of hearings is, First, there is a problem. Second, it can't be solved asymmetrically solely to OECD growth. On the other hand, it does require the United States in particular to follow the right kinds of policies if continuing growth is to be achieved and to help the problem.

Third, I think, as it has just been emphasized, it is going to have to come along with growth in developing countries.

But I guess the fourth point, which is an essential one, is that it can't happen on the cheap. I think the way in which we have approached the problem up to now, whether you think of creative accounting, whether you think of bailing the banks in, whether you think of one or another mechanism here, it has really been to avoid facing up to the problem that we are unwilling to put up public money in order to deal with the problem.

I think the developing countries understand very well that the bonanza period is over, that they are going to have to increase savings rates, they can't rely on financial markets the way they did previously.

But I think over this transition, unless there is going to be some public money that is going to be put up—and much of it in the guise of supporting the multilateral institutions—then I think one cannot be very optimistic that there is a solution ahead.

Senator **Mathias**. Peter, do you have any last words?

Mr. **Jones**. Only that this combination of $20 billion from the private banks and $9 or $10 billion from the development banks that Secretary Baker is talking about over the next 3 years is most encouraging. If it is accomplished and if one other thing is accomplished—and that is, the general capital increase of the World Bank of $40 to $50 billion, which is the target, then we will definitely be moving in the right direction

If this package is supported by the administration, as it looks like it will be, and by the Congress, and is used by all concerned to leverage further private lending and foreign direct investment, that combination can do much of our part of what's required.

I think the only other thing, as Bob Heller said, the role of the U.S. Government itself. With all of our own problems and budget deficits, it is still going to be necessary, particularly with the general capital increase of the World Bank, for the U.S. Government to provide a small portion of that, but happily it is less than a billion dollars in new U.S. paid in capital that's required.

And that is why we count on you, Senator, to help lead the Senate for, and Secretary Baker to lead the administration for.

Mr. **Knapp**. Senator, may I just make a quick comment?

Senator **Mathias**. Surely.

Mr. **Knapp**. This $40 billion figure frightens everybody. They fall over backward when they hear the World Bank needs $40 billion.

But U.S. share of that will be about 20 percent. We are down to 8 billion. Less than 10 percent would be paid in. We are down to a few hundred million dollars. That is all we are talking about, a few hundred million dollars.

So don't let that $40 billion bedazzle anybody.

Mr. **Jones**. The only other thing I want to say both on behalf of the World Affairs Council and the Bay Area International Quorum and all of us that worked with you on this, we are terribly grateful to you for coming out here and holding these hearings.

Senator **Mathias**. Well, on the contrary, the committee generally, and I personally, am very grateful to you and to all the participants here, those who have helped with the arrangements and those who have come here to testify.

And I think we made a good record, a record that will be useful to the Congress, and more broadly, useful to the public which is concerned with this problem.

I think there is some original testimony, which is something to be celebrated. Because in my experience, original testimony doesn't happen all the time.

So I would like to express the appreciation of the committee and my own thanks.

[The following information was subsequently supplied for the record:]

The Role of Foreign Direct Investment in the Debt Crisis of the Developing Nations and its Relation to U.S. Growth

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October 1985

The Role of Foreign Direct Investment in the Debt Crisis of the Developing Nations and Its Relation to U.S. Growth

Peter T. Jones

Yesterday we heard strong evidence and experienced judgement that in the critical next three years rekindling substantial per capita growth is critical to the vital interests of both the U.S. and the debtor nations.

We also heard that this cannot be accomplished without more foreign exchange flows to these nations than will take place from their export earnings and new voluntary lending from private foreign banks. These two sources are essential but now clearly insufficient to renew per capita growth. Such renewed per capita growth must be achieved in the next three years to prevent:

1. serious damage to the international financial system which would result from large-scale de facto defaults;

2. political destabilization of existing governments with ensuing danger to U.S. and Latin security interests and further risks to the international financial system;

3. further loss of U.S. exports, related jobs and growth and longer term U.S. competitiveness in the global economy by rendering inoperative our traditional commercial and geographic advantages over our Asian competitors with the debtor nations of Latin America.

One and two years ago Latin exports and restored creditworthiness, so as to produce renewed voluntary foreign lending, were touted as the sufficient solutions to the external needs of these debtor nations. When it became apparent that they were necessary but insufficient solutions to the external sector requirements, some in the administration announced that foreign direct investment would do the rest.

That has now proved as illusory as the earlier hope that exports and voluntary lending would be sufficient. Again, the time frame is the next three years. Everything could blow if additional internal and external resources beyond that provided by market forces alone are not mobilized.

Why will not foreign direct investment solve the short-term three year problem? Because it will not happen in sufficient amounts to provide the additional external capital flows required to renew per capita growth and meet foreign debt service requirements.

Without renewed per capita growth, the risks are too great and the potential rewards are too small and there are too many more attractive lower risk rewards available elsewhere.

The principal reasons for the high value of the dollar are high interest rates, and the fact that the U.S. is perceived by investors as a "safe haven." Money leaves Europe and the Far East to invest in the U.S. for both reasons. With Europe and Japan committing to stimulate higher rates of growth at home, there will be two additional regions of the world with enhanced risk reward ratios which will be relatively that much more attractive for foreign direct investment than will the heavily indebted nations of Latin America and elsewhere. Since most of the foreign direct investment capital is controlled by large multinationals which are not, in the main, venture capitalists or speculators by nature -- either at home or abroad -- most of that FDI will not be attracted to opportunities for high risk high reward in their debtor nations. Because of the lack of overall growth of these debtor nations, investment prospects just do not appear attractive.

The slow turnaround response time of most multinationals to improved conditions abroad adds to the evidence and experience indicating that it is wishful thinking to believe that foreign direct investment is going to fill the gap.

In any event most direct foreign investment flows occur amongst the advanced nations. According to IMF calculations in recent years direct foreign investment has only accounted for some 10 percent to 12 percent of the financial flows to the 25 developing countries with the largest external debt.

However, the contribution to development usually made by foreign direct investment is disproportionate to the dollar amounts involved because of the technology and management knowhow that accompany it and because equity is automatically self adjusting to economic downturns in ways debt is not. Nonetheless, it has been a relatively small portion of total financial flows which are at times themselves less than adequate. And since such investment only grew at an annual average 3.5 percent between 1973 and 1981 and conditions on average over the next three to five years are unlikely to be any better than those prevailing in the 1973-1981 period and quite possible worse, there is every reason to believe such investment will be less, not more, until the economic and political situation has significantly improved over present conditions. The recent study by the Group of Thirty supports this conclusion.

That is not to say that over the medium- to long-term foreign direct investment is not vitally important to debtor nations and the U.S. alike. Nor does it suggest that it is not essential for debtor and creditor governments and private sectors to work together more effectively to create the economic and political environment which will attract foreign direct investment and revenue capital flight.

The Importance of Increased Foreign Direct Investment to the U.S.

Orville Freeman's Business International recent study on "The Effects of U.S. Corporate Foreign Investment" concludes that the more U.S. multinationals invest abroad, particularly those whose investments are above average, the greater their growth of employment in the U.S. from resulting expanded exports of finished products, components, raw materials and equipment. And, in a number of cases, such investment also helps preserve U.S. companys' domestic and foreign markets which otherwise might well have been lost to foreign competition, again preserving half a loaf of American jobs which is better than none at all.

Longer term such foreign direct investment by American firms will also do much to reverse declining U.S. competitiveness at home and abroad so long as it is if accompanied by improvements in our own economy. Investment and trade are very much interdependent. Two-way trade and thus enhanced growth for all concerned is greatly strengthened by foreign direct investment. Such investment creates links between industrial and developing economies which greatly facilitate such trade. Such investment also increases the growth of the developing nations' economies which become expanded in overseas markets for our own exports.

A rising tide does in fact lift most if not all boats. And in Latin America, where we have certain historic, geographic and commercial competitive advantages over our principal international competitors, any such rising tide should be of greater relative benefit to the United States than to any other nation.

That does not mean for one minute that we might not lose those competitive advantages by failing to strengthen our competitive fundamentals here at home. We might thus lose out to others, even in Latin America. But it need not happen and it should not happen, and with the belated awakening of U.S. industry to the competitiveness issue I would bet it will not happen.

Thus more, not less, U.S. foreign direct investment, especially in Latin American (which contains the largest portion of excessively indebted developing nations) would be very much in U.S. national interest in terms of long-term competitiveness. It would also assist growth and thus political stability of Latin America, and help avoid future possible threats to the international financial system. This is partly because equity, unlike debt, is self-adjusting to periodic downturns.

The Importance of Increased Foreign Direct Investment to the Developing Nations

The most important single reason, in my judgment, for debtor nations, especially in Latin America, to drastically increase their efforts to attract foreign direct investment is to avoid stagnation and relative economic backwardness. To put it in the vernacular: Latin America has got to get with it or the world will pass it by. The pace of change which is occurring in the world is so great that if Latin America continues to be schizophrenic about foreign direct investment business the world over will soon conclude that they simply cannot waste any more time on Latin America. Priorities will increasingly shift elsewhere and more and more companies not only will not invest, they will increasingly disinvest. That means the capital, and perhaps even more importantly the technology and managerial know-how necessary to remain or become competitive in this rapidly changing world just won't come. The risk of at least some of these nations falling further and further behind is clear and present.

But that requires at least two things directly linked to attracting such investment:

1. Debtor nations in the developing world must restore sustained per capita growth. This is only possible if both we and they do our share in our mutual interests.

2. Developing nations, especially in Latin America, must take active steps to become less hostile and more affirmatively hospitable to such investment or other devel-

oping nations in Asia and elsewhere will attract capital which might otherwise go South.

A recent review by the World Bank staff of the role of foreign investment in economic development reached the following five basic conclusions which I largely share:

1. "Equity forms of investment can clearly be beneficial to developing countries and it is desirable that they be increased. Developing countries can reduce the level of risk attached to external capital inflows and secure the benefits of technology and expertise transfers by expanding the amount of direct investment in total external financing."

2. "Given that equity investment is desirable, there is a question of how developing countries might attract it and use it efficiently. Experience over the last decade suggests that countries with stable economic and political environments and a system of relative prices that reflects opportunity costs are the most successful in this regard. Some countries have succeeded in attracting direct investment by offering inducements of various kinds but these normally encourage inefficient investment and malpractices in investing firms. Special incentives can be costly for individual developing countries, and offsetting within developing countries as a group. In general, developing countries benefit most from equity forms of investment when the overall policy environment is favorable and when the policies adopted towards foreign investors are the same as those under which domestic investors operate."

3. "Policies in industrial countries are also important for encouraging equity flows; liberal trade and industrial policies are most conducive to direct investment in developing countries. Bilateral understandings and insurance schemes have also proved uiseful in mitigating some of the risks inherent in direct investment."

4. "While all of the above factors could encourage a greater flow, direct investment, which is undertaken by relatively few companies in a narrow range of countries

and industries, is likely to be relatively slow to respond. The evolution of indigenous stock markets and their acceptability among portfolio investors is likely to be a slow process."

5. "Both direct and portfolio investment have the potential for covering a higher proportion of the funding needs of developing countries than they have up to now. To realize this potential, however, requires a significant reassessment of the benefits of those types of investment in host and investing countries alike. The relative size of private direct investment countries alike. The relative size of private direct investment by comparison to commercial bank and other private capital flows suggests, however, that while equity flows can be an increasing proportion of total capital flows, they cannot by themselves substitute in the medium term for a significant decline in other private capital flows to developing countries. But given the complementary relationship between equity flows and other capital flows, an improved environment towards the former might help stimulate the latter."

How can American Multinational Corporations Best Advance the Interests of Themselves, the U.S. and the Debtor Nations?

Over the longer term U.S. multinational corporations have a vital role to play in protecting their own interests and those of the U.S. and especially the democratic elements in the debtor nations.

There are five common failings of U.S. corporations doing business in Latin America which seriously handicap them in successfully pursuing the mutual interests of all concerned. While there are, as always, some exceptions to these five failings, they are and have been sufficiently prevalent over time to warrant recording here, especially since Latin America can be a growing potential importance to the U.S. in its future efforts to strengthen our own international competitiveness for reasons discussed above.

First, American corporations like American banks must not yield to their instinctive individual preservationist tendencies and conclude that the risk of the debt crisis getting out of hand is about to happen, enveloping existing foreign enterprise and leaving a wasteland in which no future foreign investment or lending can bear fruit for a long time. The reaction often seems to be wherever you can, cut back or cut out, retrench or retire; and under no circumstances increase your investments or loans or your efforts to eliminate, or safely contain, whatever inflammabnle problems exist in some nations. Head for the hills.

It seems obvious that such a reaction is the only one virtually guaranteed to bring about the very thing most feared. Nature abhors a vacuum and so does politics and economics. In certain countries today, a void left in the private sector will most likely be filled by the public sector, by a "magical" process commonly known as creeping or galloping socialism.

Second, although the specific tactics and prospects for coping with this danger will vary widely from country to country, there is obviously only one general strategy which can permanently prevent an ever increasing takeover by the public sector. That is to build a dynamic, modern and responsible *overall* outward looking private sector with a sufficiently broad base of economic and political strength to establish a balance of power and *modus vivendi* with the forces of nationalism, statism and isolationism in the country. In some countries this will increasingly require that a sizeable portion of the population and important elements in the power elites have a direct personal financial stake in the profits and growth of the private sector. Only when a major and growing portion of the populace knows that when it sacrifices today's consumption for tomorrow's growth, it will share directly in the fruits of that sacrifice, will some nations continue to have a vigorous private sector. And in certain Latin republics more and better jobs and wages will not be a sufficient financial stake to do the job. There only a widely-shared direct participation in profits and equity ownership will create a power base equal to the task of permanently containing statism.

Third, in today's period of rising nationalism and related risks of excessive statism, for a private sector to be strong enough to contain the forces of statism it must be predominantly controlled by local interests. Foreign firms must play an ancillary role.

The reason is as obvious as the conclusion. The active use of political power by the private sector is a *sine qua non* to the successful containment of statist forces in many Latin countries today. Foreign private enterprise is effectively barred by nationalism from using most political weapons. Thus if foreign enterprise dominates the private sector, the local firms will be too weak to hold their own in the political arena.

Fourth, since a sufficiently strong overall private sector not only requires local predominance but also local modernity U.S. managerial and technological know-how must be transferred to locally owned firms to a far greater extent than at present. This means more not less joint ventures and more U.S. business involvement in Latin business and engineering schools.

Fifth, when U.S. companies have a major R&D or production problem, they usually bring in the best and most up to date experts available to solve the problem. When they have a major line job to fill, they usually seek the best, most experienced man -- and pay accordingly. But when it comes to the political problems of nationalism, statism, isolationism and anti-americanism in Latin America, many U.S. firms do not seek or use the most up-to-date area knowledge or experts in making key policy decisions. This is one of the few areas still left to the amateurs or second-raters in too many companies.

The unwillingness of numerous U.S. firms to assign an adequate priority to this essential aspect of doing business in Latin America is also sometimes exemplified by their unwillingness to contribute adequate funds or time of one of their senior officials with up-to-date area knowledge to the Council of the Americas so as to help it realize its full potential in helping U.S. business to cope more effectively with the forces of instability, slow growth, nationalism and statism.

Finally, having identified where American business is often wanting, I do believe that a substantially greater degree of cooperation between U.S. business and the U.S. government where vital national interests are at stake can be achieved. I also believe the pragmatic ingenuity, energy, abilitv, and creativity of U.S. business can be applied to improve U.S. competitiveness. U.S. business and the U.S. government are capable of rising to the challenge and succeeding. To do so we must be committed. The stakes are high, and we cannot afford to fail.

Senator **Mathias**. If there is nothing further, the committee will stand adjourned subject to the call of the Chair.

[Whereupon, at 11:50 a.m., the Subcommittee on International Economic Policy of the Committee on Foreign Relations, was adjourned, subject to the call of the Chair.]

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